WAL★MART
Financial Services

Jane Thompson, President
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702 SW 8th Street
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October 10, 2006

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

Dear Mr. Feldman:

We appreciate the opportunity to respond to the questions published by the FDIC on August 23, 2006 regarding issues related to Industrial Loan Corporations (ILC).

In the attached response, we have addressed the twelve questions posed by the FDIC. In summary, we believe the current ILC regulatory framework as it exists today has been demonstrated to be comprehensive, rigorous, effective and appropriately tailored to the institutions that are regulated.

As it relates to the Wal-Mart Bank application, we would like to reiterate that we are fully committed to meet all statutory factors necessary to obtain federal deposit insurance.

We acknowledge the requirements to meet the established regulatory standards, including, but not limited to, compliance with the law, independence from the parent company, protection of the insurance fund, adherence to safety and soundness and meeting the needs and convenience of the community through our robust CRA plan.

In addition, as we have stated several times publicly in oral and written testimony, our business plan does not include branch banking and we fully expect to receive a condition stating such a restriction.

We look forward to our application being judged and evaluated on its merits.

Thank you again for the opportunity to participate in this important effort.

Sincerely,

Jane J. Thompson

Jane J. Thompson
Senior Vice President, Wal-Mart Stores, Inc.
President, Wal-Mart Financial Services

Attachment

Comment Submitted By
Wal-Mart Stores, Inc.,
In response to the
Notice and Request for Comment
concerning
Industrial Loan Companies and Industrial Banks

Published by the
Federal Deposit Insurance Corporation
August 23, 2006,
71 Fed. Register 49456

Submitted October 10, 2006

This Comment has been prepared by Wal-Mart Stores, Inc. ("Wal-Mart")[1] in response to questions posed by the Federal Deposit Insurance Corporation ("FDIC") in a Notice and Request for Comment concerning Industrial Loan Companies and Industrial Banks[2] published August 23, 2006, 71 Fed. Register 49456-49459 (the "Request"). We appreciate the opportunity presented by the Request to address the important issues raised therein. The Request was made in connection with the moratorium on certain FDIC actions with respect to applications and notices for the establishment or acquisition of ILCs. *See* Moratorium on Certain Industrial Loan Company Applications and Notices, 71 Fed. Reg. 43842-44 (Aug. 1, 2006) (the "Moratorium").

It is important to state at the very outset that we firmly believe that the FDIC could have acted on the applications made subject to the Moratorium with absolute confidence in its ability (and that of the State of Utah) to supervise the ILCs at issue, including Wal-Mart's proposed bank, and their parent companies and affiliates in a manner that assures safe and sound operation, avoids risk to the insurance fund and assures the highest standards in dealing with potential conflicts of interest.

As we discuss more fully below:

- ***Two decades of history and performance demonstrate that ILC organizations pose no unusual risks or problems, and new applications do not change that conclusion.***

- ***The FDIC and the State of Utah have a long track record of successfully supervising ILC organizations in a manner that is comprehensive, effective and tailored to the facts and circumstances posed by a particular organization (whether predominantly traditional banking, nonbank financial or commercial).***

- ***The Bank Holding Company (BHC) Act plainly permits a retailer or other commercial enterprise to control an ILC.***

- ***Applications and notices should be decided by the FDIC on their individual merits and there is no basis in law or experience for denying an application solely because of a proposed affiliation with a retail or other commercial firm.***

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[1] This comment was prepared with the assistance of Cantwell F. Muckenfuss III, Robert C. Eager and Christopher J. Bellini of Gibson, Dunn & Crutcher LLP with respect to federal issues and of Jerold G. Oldroyd of Ballard Spahr Andrews & Ingersoll, LLP with respect to Utah issues.

[2] In keeping with the terms of the Request, we use the term "ILC" to refer to both industrial banks and industrial loan companies.

A number of the questions posed by the FDIC are framed in the terms used by critics of the existing legal framework governing ILCs, and we appreciate the opportunity to respond to these criticisms as presented. Despite the rhetoric of ILC opponents, their arguments have, in truth, raised no new substantive issues.[3]

Even though we believe the FDIC has a duty to make timely decisions on pending applications, the Moratorium and the Request do, nevertheless, provide the FDIC a timely opportunity for a rigorous, comprehensive and thoughtful review and discussion of the regulation and supervision of ILCs and their parents. In view of the many assertions made about ILC organizations and their supervision, this pause will allow the FDIC to assess the questions and concerns raised in a manner that is transparent and grounded in fact and analysis. In that spirit, we have responded to each of the questions in the Request. The following summarizes the core points of our analysis:

***Two decades of history and performance demonstrate that ILC organizations pose no unusual risks or problems, and new applications do not change that conclusion*.** Critics of ILC organizations have repeatedly asserted that somehow recent ILC applications pose new and special risks and challenges. Nothing could be further from the truth. There is an extensive record of ownership of insured depositories by commercial firms or entities which own commercial firms. This history should be examined carefully and in detail by the FDIC as part of the analysis resulting from the Moratorium Based upon our understanding of these facts, we believe that this review will demonstrate that:

- depository institutions owned by or affiliated with commercial enterprises have rarely posed significant supervisory problems;
- the record of safe and sound operations compares favorably with other categories of insured depositories;
- the record of enforcement actions with respect to these institutions is comparable to, if not better than, other insured banks;
- commercial firms were an important source of capital and stability to the thrift industry during the depths of the thrift crisis;
- ownership of these institutions by commercial firms provides an important vehicle for serving customers in an innovative, convenient, and often lower cost, manner;
- commercial firms have understood their stewardship as owners and respected the rules concerning serving as a source of financial and managerial strength, affiliate transactions and tying; and

[3] *See* footnote 13, *infra.*

- the facts strongly support the conclusion that both the FDIC and the State of Utah (and, in the case of thrift institutions, the Office of Thrift Supervision ("OTS")), have been able to supervise insured depositories owned or affiliated with commercial firms in a robust and effective manner that fully encompasses the risks and implications of such control and affiliations.

We believe that the ILC critics bear a heavy burden at this point. In the extensive FDIC hearings with respect to the Wal-Mart application, and in the hearings in the July 2006 House Financial Services Committee, no one pointed to specific problems nor, indeed, identified any sound reasons why ILCs, their parents and affiliates pose any greater risk to safety-and-soundness or the Deposit Insurance Fund than other forms of depository organizations. Instead, the critics have repeated unsupported assertions and general concerns about ILC organizations based on fundamentally flawed premises and a selective and inaccurate view of the FDIC's legal authority and supervisory practices. Indeed, we believe that the FDIC's review of the facts will support the conclusion that ILCs and their affiliates actually pose less risk to the fund than insured banks generally (whether free-standing or in a bank holding company).

The FDIC and the State of Utah have a long track record of successfully supervising ILC organizations in a manner that is comprehensive, effective and tailored to the facts and circumstances posed by a particular organization,(whether predominantly traditional banking, nonbank financial or commercial). For more than two decades, the FDIC has addressed supervisory issues presented by nonbanking and nonfinancial parents and affiliates of insured banks engaging in activities not then permitted to bank holding companies, including ILC organizations. We believe the record reflects that the FDIC has consistently and effectively addressed those issues in a manner that addresses the safety and soundness of individual banks, minimizes risk to the Deposit Insurance Fund, and promotes the stability of the financial system.[4] Throughout this period, through rules, orders, and supervisory policy and practices, the FDIC has given extensive attention to the role and effects of the parents and affiliates of the insured banks it supervises to ensure that those relationships take place on a basis consistent with

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[4] We would underscore the point that ILCs are insured state nonmember banks and that they and their affiliates are subject to the entire panoply of federal laws and FDIC rules that govern nonmember banks generally. *See* the FDIC's letter at Appendix III. GAO report GAO-05-621, Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority, released on September 22, 2005, http://www.gao.gov/new.items/d05621.pdf. ("2005 GAO Report"). *See* also FDIC Office of Inspector General (OIG), *The FDIC's Industrial Loan Company Deposit Insurance Application Process*, Report No. 06-014, July 2006 ("2006 FDIC/OIG Report") at 4 and Appendix XI (p. 48). ("The FDIC has implemented a comprehensive process and procedures for reviewing, investigating, and approving deposit insurance applications, . . . The Corporation's monitoring processes provide a reasonable supervisory approach to help ensure that ILCs adhere to the conditions imposed upon them, including those associated with business plans.")

these same institutional, FDIC, and systemic goals.[5] There is simply no evidence that FDIC supervision of ILC companies has been inadequate.

Several of the questions raise the issue whether the FDIC should distinguish among ILC owners based upon whether the enterprise is subject to "consolidated supervision."[6] A fundamental point typically ignored by critics is that in the Federal Deposit Insurance ("FDI") Act, Home Owners Loan Act ("HOLA"), and the BHC Act, Congress adopted and has maintained for many years three materially parallel statutes for providing comprehensive regulation and supervision of insured depository institutions and their affiliates.[7] Under a parallel, yet distinct statutory framework, the Securities and Exchange Commission ("SEC") now comprehensively supervises certain securities firms with ILC affiliates. The FDIC has all necessary powers under existing law to assure that it can provide all needed safeguards to an insured bank affiliated with a commercial firm in a manner that parallels and is as comprehensive and effective as the other federal regulatory regimes. Critics who suggest otherwise simply are ignoring the terms and express scope of the FDI Act. Under present law, the FDIC has plenary authority to ensure that such affiliations pose no threat to the affiliated bank's safety-and-soundness, to the FDIC fund, or to the financial system.

It should be noted that ILC critics in effect assert that "consolidated supervision" means only the approach to bank holding company supervision implemented under the BHC Act.[8] As the framing of the question reflects, the BHC Act approach is only one of several to which the

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[5] The FDIC has spoken to these issues in the past: "I am very proud of our record supervising ILCs and the other 5,000 state-nonmember institutions we regulate. Let me be very clear: The ILC banks are subject to the exact same regulatory oversight and laws as the other 5,000-plus banks and thrifts for which the FDIC is the primary supervisor. . . . [T]hese organizations are rigorously and sufficiently supervised by the state supervisors and by the FDIC on an ongoing basis. Now, there have been questions about the oversight of their parent companies - many of which are commercial firms. While I understand these concerns, the FDIC has - and often uses - a number of tools to manage both the holding company's involvement with the financial institution, and to manage transactions between the two entities." *See* CSBS Remarks, *infra* at n. 13.

[6] The critics also fail to recognize that, whatever label is applied, the FDIC has a very long track record of effectively supervising diversified and commercial companies that control insured banks that are not BHC Act "banks."

[7] Although parallel, the regimes have been implemented in different ways. An obvious difference between the OTS and Federal Reserve Board ("Fed") regimes is that S&L holding companies are not subjected to the bank-like Basel risk-weighted capital requirements that apply to all bank and financial holding companies under the Fed regime.

[8] *See, e.g.*, 2006 GAO testimony, http://www.gao.gov/new.items/d06961t.pdf

label "consolidated supervision" has been applied over a 15 year period by U.S. and European Union ("EU) financial regulatory agencies.[9]

The Bank Holding Company (BHC) Act provision plainly permits a retailer or other commercial enterprise to control an ILC. Congress amended the BHC Act in 1987 to permit any type of company, including a retailer, to control an ILC (subject to stated statutory requirements) without becoming a BHC. In 1999, after states such as Utah had actually broadened the powers of the ILC charter, Congress made a liberalizing amendment to the BHC Act provision concerning ILCs, in the same legislation in which commercial affiliations with thrifts were restricted going forward. The BHC Act provision on its face plainly allows companies engaged in activities not permissible for a BHC, including retailers and other commercial companies, to acquire an ILC and to allow ILCs owned by such companies to operate without being subject to any cap on their growth. Section 2(c)(2)(H) of the BHC Act[10] is clear and explicit. It is not constructive or illuminating for critics to resort to a pejorative "loophole" label.[11] This provision has provided a laboratory for innovation and evolution. It should not, and cannot legally, be read out of this Act. Nor should it be eliminated now that experience has demonstrated its efficacy.

Applications and notices should be decided by the FDIC on their individual merits and there is no basis in law or experience for denying an application solely because of a proposed affiliation with a retail or other commercial firm. Several of the questions focus on whether the FDIC should treat commercial owners differently than financial owners. We respectfully submit that the answer is that they should not be treated differently. The law plainly permits a commercial firm to control an ILC without coming under the BHC Act provided that specified requirements are met. Applicants for deposit insurance or for a change of control that satisfies the requirements of that specific BHC Act provision and the requirements set forth in the FDI Act should be approved. Whether an applicant is "commercial" or financial is not a factor under the FDI Act. Accordingly, all applicants should be dealt with on a case-by-case basis in light of the statutory factors, which afford the FDIC broad latitude to address issues of safety and soundness and risk to the insurance fund, as well as the potential for illegal or abusive behavior.

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9 As set forth in Appendix 2, it is plain that the FDIC's supervision is both comprehensive and effective. We would also note that the substance of the FDIC program is comparable to the standards for consolidated home country supervision as implemented by the EU and the Fed. *See* 12 C.F.R. § 211.24(c)(ii); EFCC/BAC general guidance – USA supervision, Final 06.07.2004 at http://ec.europa.eu/internal_market/financial-conglomerates/docs/guidance-usa-final-060704_en.pdf (commenting on the OTS, the SEC and the New York State Banking Department).

10 12 U.S.C. § 1841 (c)(2)(H).

11 Under standard rules of statutory construction, Congress is presumed to intend what the laws it passes plainly provide.

These are determinations that can and should be made based upon standards and principles concerning risk-based supervision that have been developed in tandem by all the banking agencies in recent years and that are used when deciding applications, including:[12]

- the applicant organization's financial capacity and strength and its financial prospects;
- the quality of management, both of the acquirer and the proposed depository;
- the nature and soundness of the business plan and the appropriateness of proposed management in light of that plan;
- the proposed capital of the depository and ongoing access to capital;
- assurance of the ability to monitor all interaction between the depository and the owner; and
- the ability of the FDIC to effectively monitor the condition of the owner and assure that conditions at the owner do not adversely affect the depository.

These factors and others contemplated by the FDI Act (antitrust, convenience and needs, etc.) can be understood and resolved on a case-by-case basis whether the insured institution is to be owned by a broker dealer such as Merrill Lynch & Co., Inc., an insurance company such as Prudential Financial, Inc., a diversified company such as American Express, or a retailer such as Target Corporation, Sears Holdings Corporation, or Wal-Mart.

We believe that a careful review will demonstrate that the approach and practices of the FDIC and the OTS have achieved in the past and will continue to achieve in the future everything that consolidated supervision seeks to achieve. The Moratorium thus affords the FDIC an important and timely opportunity to systematically review the practices and experiences of its sister agencies in order to determine and confirm best practices and to evaluate the oversight provided in those other regimes.

The FDIC is not writing on a clean slate. There is ample history upon which the FDIC can rest its judgments, much of it in the FDIC's own files.[13] Indeed, to reiterate, ILC opponents

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[12] We note that the FDIC's Risk Management Manual of Examination Policies ("Exam Manual") includes detailed sections concerning analyzing and investigating applications. *See* Exam Manual §§ 12, 18.1.

[13] As long ago as the securities affiliate rulemaking in the mid-1980s, the FDIC has given careful consideration to the issues raised by the critics. Perhaps most noteworthy is the study completed in 1987, in which the FDIC made a thorough examination of the issues and considerations raised by permitting insured banks to be affiliated not only with financial

[Footnote continued on next page]

have raised no new substantive issues nor asserted facts or suggested analysis which undermines past conclusions.[14] The FDIC should scrutinize that history carefully and compare it with the history of firms subject to bank holding company regulation and supervision. We believe that history demonstrates that depository institutions owned by or affiliated with commercial enterprises have not posed unusual risks, have an enviable track record of safe and sound operations, and have provided substantial public benefits.

Responses to Questions Posed by the FDIC

[Footnote continued from previous page]

firms such as investment banks, but also with companies engaged in commercial activities. *See Mandate For Change: Restructuring the Banking Industry* (FDIC: 1987) ("*Mandate for Change*"). That study addressed concerns regarding conflicts of interest, affiliate transactions, safety-and-soundness, competitive equity, risk to the FDIC fund, and systemic risk. Its major conclusion was that "insulation between banking entities and the risks associated with nonbank affiliates can be achieved with only minor changes in existing rules governing the operation 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 bank affiliates are abolished. The public policy implication of this conclusion is that both the Bank Holding Company Act and the Glass-Steagall Act restrictions on affiliations between commercial and investment banking firms should be abolished." *Id.* at xiv-xv. The conclusions of that study have been emphatically confirmed by the performance of insured depositories affiliated with commercial firms. Moreover, the analysis and conclusions of the FDIC in 1987 are fully consistent with the conclusions and recommendations stated in the 1991 report, *Modernizing the Financial System: U.S. Department of the Treasury Recommendations for Safer, More Competitive Banks* [February 1991] ("1991 Treasury Report"), esp. Recommendation VII at 53ff.

More recent analyses by the FDIC have reached the same conclusion. *See* Donald E. Powell, "The ILC Debate: Regulatory And Supervisory Issues," Remarks Before The Conference of State Bank Supervisors, May 30, 2003 (PR-52-2003) ("CSBS Remarks") http:www.fdic.gov/news/news/press/2003/pr5203.html, and three recent FDIC staff studies, Mindy West, The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective, http:www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/sim04.pdf, Christine E. Blair, "The Future of Banking in America-The Mixing of Banking and Commerce: Current Policy Issues," 16 *FDIC Banking Review*, http://www.fdic.gov/bank/analytical/banking/2005jan/article3.html ("2005 Banking-Commerce Study") and the 2005 report prepared by Rose Marie Kushmeider, "The U.S. Federal Financial Regulatory System: Restructuring Federal Bank Regulation**,"** 17 *FDIC Banking Review* (December 2005) (herein, "2005 Restructuring Report"), esp. at 13-15, http://www.fdic.gov/bank/analytical/banking/2006jan/article1/index.html.

[14] As was recently stated, "some opponents of ILCs may be blurring the facts in order to make their case." CSBS Remarks, *supra*.

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?

Response: Developments in recent years have not altered the risk profile of ILCs compared to other depository institutions, and indeed we believe the evidence supports the view that risks associated with ILCs compare favorably with the rest of the banking industry. The growth and development of ILCs poses no new concern for safety-and-soundness for the FDIC fund or for the industry as a whole. In view of the fact that the FDIC has an excellent track record of modifying and updating its supervisory programs to take account of the evolution and development of the banking industry, including ILCs, (see Appendix 2) we believe no significant changes are presently necessary. The FDIC could, as suggested below, consider whether there are benefits to codifying its policies and practices for regulating large or complex companies through a notice and comment rulemaking. The adoption of such a rule might serve to dispel doubts regarding the FDIC's authority and capacity in this regard.

ILC RISKS ARE NO GREATER THAN OTHER BANKS' RISKS AND LIKE OTHER BANKS DEPEND UPON SPECIFIC CIRCUMSTANCES. We know of no evidence that suggests that ILCs present new, unusual or undesirable risks to the Deposit Insurance Fund.[15] Nor do the applications before the FDIC appear to change that pattern. In every case, both existing and new entrant ILCs engage in banking and financial activities that are common in the banking industry, even when they focus on a particular niche customer base.[16] Moreover, the

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[15] The consistency of the FDIC's experience and analysis over more than two decades is particularly noteworthy. *See generally Mandate for Change*, esp. at 15 (commercial affiliates of "nonbank banks" in 1987), 63, 74-75 (in general, "commercial" activities no riskier than financial activities). The CSBS Remarks, *supra*, reflect two decades of FDIC experience and state that the present ILC structure poses no greater safety-and-soundness risks than do structures involving other types of banks or thrifts: "It is important to note here that risk posed by any depository institution depends on the appropriateness of the institution's business plan and model, management's competency to run the bank, the quality of the institution's risk-management processes, and, of course, the institution's level of capital. . . . 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. In part, the generally positive experience of the ILC charter in recent years is attributable to a continually evolving supervisory approach that considers each institution's purpose and placement within the organizational structure."

[16] *See generally* the overviews of the industry in the testimony and speeches of Utah Commissioner G. Edward Leary: http://www.dfi.utah.gov/PDFiles/IB%20Congressional%20Testimony%20-%20ELeary.pdf

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business plan of each new entrant is subjected to close scrutiny by the FDIC and state agency and will not be permitted to go forward if it presents unacceptable and unmanageable risks. The agencies are well equipped to assess the risks entailed, both for new entrants and on an ongoing basis.

A brief review of the FDI Act reveals the scope of the FDIC's supervisory powers to address risk. The FDIC has express power "to make such examinations of the affairs of an affiliate of a depository institution as may be necessary *to disclose fully* . . . (i) the relationship between such depository institution in any such affiliate; and (ii) the effect of such relationship on the depository institution." 12 U.S.C. §1820(b)(4)(A) (emphasis added). These broad express powers are further expanded by the statutory grant to the FDIC to "exercise by its Board of Directors, or duly authorized officers or agents, all powers specifically granted by the provisions of this Act, and such incidental powers as shall be necessary to carry out the powers so granted." 12 U.S.C. 1819(a) Seventh. In view of the broad scope the Supreme Court has given to "incidental powers" in a banking context,[17] it is plain on the face of the statute that the FDIC has plenary powers. Accordingly, the FDIC can gather all pertinent information concerning any risks raised for the banking system from an ILC's relationship with its affiliates and can take appropriate follow-up action.

Further, systemic risk may actually be reduced by affiliations of ILCs with commercial firms. These affiliations bring important additional financial and managerial resources to the banking system.[18] The importance of this factor was underscored during the difficult period of the late 1980s and early 1990s. This point should not be forgotten after an extended period in which we have avoided banking stress. In addition, the FDIC benefits from the supervisory insights and understanding it develops through its supervision of the large complex organizations of which many ILCs are a part.

In sum, as suggested in these responses, the FDIC has the authority and has demonstrated the skill and rigor through existing policies and programs to assure that ILCs operate in a safe and sound manner and pose no threat to the Deposit Insurance Fund or the financial system. The FDIC should continue, with its sister agencies, to encourage and foster best practices in risk management and to understand and carefully oversee innovations and unique business plans. In view of apparent misunderstanding of the scope of the FDIC's authority and practices, the FDIC may also wish to consider codifying its existing policies and procedures through a rulemaking.

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(House Subcommittee testimony); http://www.dfi.utah.gov/PDFiles/IB%20Speech%202006.pdf *See also* CSBS Remarks, *supra*.

[17] *See NationsBank v. Variable Annuity Corp,* 513 U.S. 251 (1995).

[18] We note, for example, that Wal-Mart has made a start-up capital commitment that is a multiple of the other liabilities projected for its proposed bank and has formally committed to be a source of strength to the bank.

ILC GROWTH PALES BY COMPARISON TO BANKING INDUSTRY GROWTH. ILC critics have pointed to the percentage rate of growth of ILCs since 1987 to suggest that this growth is a source of new risks or problems that must be addressed. We believe that the growth of ILCs provides no basis for any new or particular concern, and indeed that such growth is insignificant in the context of growth changes in the banking industry as a whole over the last two decades.

It is indisputable that the total assets held by ILCs have grown significantly in percentage terms over the last 20 years, but this gain is largely explained by the fact that ILC assets were miniscule in 1987. Indeed, assets of industrial banks totaled only about $155 billion as of March 31, 2006, of which $127 billion are in Utah institutions. Total deposits of all ILCs in Utah amounted to only $94.5 billion at year-end 2005. The bulk of this growth has occurred in the subsidiaries of a handful of large well-regarded companies: the five largest ILCs have combined total assets of about $110 billion and total deposits of $84 billion.[19]

Nevertheless, in the context of the banking industry as a whole, the growth of ILCs, whether measured in deposits, assets, or number of applications filed, is insignificant. At the end of 2005, ILCs accounted for only 1.5% of the total assets of all insured banks.[20] Their relatively small size also indicates that the risk posed by ILC growth almost certainly is less than the risk posed by the growth of insured banks generally.

The relative insignificance of the growth in ILCs is most graphically demonstrated by comparison with the largest banking organizations, *each* of which grew more over the last two years than all ILCs combined grew during the past 20 years. The following statistics about growth in the banking industry as a whole and of ILCs demonstrates how the growth of ILCs is unremarkable and does not reflect a change in the regulatory or supervisory approach by the FDIC.

Deposits. A table published by the *American Banker* in May 2006 surveyed the growth in deposits held by the banks in the largest bank and thrift holding companies as measured at year-

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[19] Based on FDIC figures. Utah Commissioner Leary recently provided an overview of the industry: "Industrial banks are owned by a diverse group of financial and commercial firms. Of the 61 existing industrial banks, 43 are either independently owned or affiliated with a parent company whose business is primarily financial in nature. These 43 comprise approximately 90 percent of the industry's assets and deposits. The remaining 18 are associated with parent companies that can be considered nonfinancial. They account for approximately ten percent of industrial bank assets and deposits." http://www.dfi.utah.gov/PDFiles/IB%20Speech%202006.pdf.

[20] *See* http://financialservices.house.gov/media/pdf/071206gel.pdf; *see also* http://www.federalreserve.gov/pubs/bulletin/2006/bank_condition/default.htm.

end 2002-2005.[21] In that survey, the total aggregate deposits of the banks in the four largest BHCs (Bank of America, Citigroup, JPMorganChase and Wachovia) increased in 2004-2005 as follows: B of A by $221 billion (53%); Citi by $119 billion (25%); Chase by $229 billion (70%); Wachovia by $101 billion (45%). Thus, aggregate bank deposits for *each* of these companies grew during two years by more than deposits grew at all the Utah ILCs combined over almost two decades. Together, the top five insured banking organizations experienced total deposit growth during the past four years (2002-2005) of $891 billion. The growth during the past four years is more than 925% of total Utah ILC deposit growth over almost two decades.[22]

A comparison with the growth in deposits of the largest ILCs as provided in their Call Reports over the same four-year period is also striking. As of year-end 2002, Merrill Lynch Bank USA ($55,689,434,000); American Express Centurion Bank ($7,487,901,000 (including gross foreign and domestic deposits)); and Morgan Stanley Bank ($1,994,159,000) had total deposits of $65,171,494,000. By the end of 2005, these three ILCs had a total of $63,970,762,000 in deposits (Merrill Lynch Bank USA ($52,724,538,000); American Express Centurion Bank ($5,586,791,000); and Morgan Stanley Bank ($5,659,433,000)) – an overall *decline* of 1.8%.[23]

Assets. Between 2000 and 2006, the total assets of the ten largest bank holding companies increased by $5.4 trillion, or more than 250%, from $3.3 trillion to a combined total of $8.7 trillion. Between 1990 and 2006, total assets of the top ten bank holding companies grew by more than 925%. During this same period, the total assets of the largest bank holding company, Citigroup (Citicorp in 1990), increased by more than 725%, from $216 billion in 1990 to $1.58 trillion in early 2006. The second largest BHC, Bank of America, experienced even greater growth: it grew by over 1000%, from total assets of $110 billion at the end of 1990 to total assets of almost $1.4 trillion as of March 31, 2006.[24] By comparison, the $155 billion growth in total ILC assets between 1987 and 2005 is insignificant.

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21 Bank and Thrift Holding Companies with the Most Deposits, 2002-2005 (Year-end totals, May 19, 2006) http://www.americanbanker.com/rankings.html?rankingchart=/BTHC/Deposits/051906RTBSuppBHCMostDeposits5-Years.htm.

22 *Id.*

23 Based on FDIC Reports of Condition filings as of December 31, 2002, and December 31, 2005.

24 Sources, American Banker: http://www.americanbanker.com/rankings.html?rankingchart=/BTHC/Assets/072006BTHC_Assets.htm; http://www.americanbanker.com/rankings.html?rankingchart=/BTHC/Assets/Top100Q12000html; *Ranking the Banks, 1991, American Banker archive.*

Applications. The 2006 FDIC OIG Report reports that during the five years ending December 2005, the FDIC approved deposit insurance applications for 780 institutions, of which 19 were for ILCs.[25]

These numbers speak for themselves and suggest that those who have said that the growth of ILCs is "remarkable" or raises "acute" public policy issues[26] are exaggerating.

The facts concerning the ILC industry provide no basis for the FDIC to attempt to use its administrative authority to block establishment of new ILC-commercial affiliations or to "shut down" or restrict across the board existing ILCs with such affiliations. Moreover, the courts have made it plain that applications must be judged based only on statutory factors. *See Western Bancshares, Inc. v. Board of Governors*, 480 F.2d 749, 750 (10th Cir. 1973).

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?

Response: No. There is simply no evidence that the risks posed by an ILC or any depository institution are greater as a consequence of the nature of the owner. The FDIC has thoughtfully and thoroughly studied these issues for more than two decades and has consistently concluded that "commercial"-bank affiliations pose no special risks and can be effectively supervised under existing law and FDIC supervisory programs.[27]

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[25] FDIC Office of Inspector General, The FDIC's Industrial Loan Company Deposit Insurance Application Process, Report No. 06-014, July 2006 ("2006 FDIC OIG Report") http://www.fdicig.gov/reports06/06-014.pdf.

[26] *See* Alvarez testimony, July 12, 2006, at 1. http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=487&comm=3.

[27] The comprehensive analysis set forth in *Mandate for Change, supra*, came to this conclusion: "As a rule, . . . it likely will be difficult to generalize about the relative riskiness of different activities for banks. In particular it is apparent that commercial and financial activities will not be distinguishable on the basis of any inherent differences in risk." *Id*. at 63. Two decades after the nonbank bank debate focused attention on theses issues at the FDIC, the analysis of the FDIC was the same: "We at the FDIC must all be vigilant in our supervisory role. But I will reiterate: The FDIC believes the ILC charter, *per se*, poses no greater safety and soundness risk than other charter types." CSBS Remarks, *supra*, http://www.fdic.gov/news/news/press/2003/pr5203.html.

Indeed, the evidence supplied by more than 20 years of experience demonstrates that nonfinancial affiliates of insured depository institutions, including ILCs, have been good stewards and have been a consistent source of financial and managerial strength for their depository affiliates. Consistent with the existing practice of the banking agencies, supervision should be tailored to the particular characteristics and business plan of the depository institution and the risks (if any) posed by its parent and affiliates, whether commercial or financial in nature.

NO EVIDENCE SUPPORTS DIFFERENTIAL TREATMENT OF "COMMERCIAL" AFFILIATIONS. We believe that no one has demonstrated any grounds for the FDIC to apply its supervisory or regulatory authority differently based on whether the owner is a financial entity or a commercial entity. The consistent findings have been that there are no special risks posed by ILC organizations or by other bank-"commercial" affiliations.[28] We believe the burden should fall squarely on those who assert otherwise to come forward with factual evidence or sound economic analysis to support a different conclusion.

ESTABLISHED CASE-BY-CASE SUPERVISORY METHODS ARE SOUND AND EFFECTIVE. Well-established principles and practices of risk-based bank supervision and regulation call for supervision to be implemented based upon the facts and circumstances of the particular organization in question including its financial and managerial strength, the scope and ambitions of its business plan and the realities of the market in which it operates. Bank and financial supervision and regulation can and should be tailored depending on management, business plan, complexity, size, and riskiness of operation. The agencies can and should distinguish between a large complex multinational operation that has wholesale and retail operations and an organization that provides retail services on a regional basis. Put simply, State Street Corp. and Citigroup are very different organizations and, even within the overall BHC framework, should be regulated differently.[29] And similarly, the regulation and supervision of

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[28] "[W]e at the FDIC have not identified any safety and soundness concerns unique to ILCs," CSBS Remarks, *supra; see Mandate for Change, supra,* chapters 5 and 6.

[29] As the Fed's supervisory letter concerning its Large Complex Banking Organization (LCBO) program states: "The Federal Reserve's supervisory approach recognizes that dramatic changes in the financial, technological, legal, and regulatory environment necessitate a flexible supervisory framework that includes the ongoing review and assessment of LCBO risk profiles and the continual adjustment of supervisory plans and programs for individual institutions. * * * Key elements of the Federal Reserve's supervisory approach for LCBOs include the following: . . . Assignment to each LCBO of a dedicated supervisory team and staff with specialized skills, knowledge and experience tailored to the unique profile of the particular institution. * * * Effective risk-focused supervision requires the development and maintenance of a supervisory plan that is current and relevant to the organization's changing risk profile. In addition to addressing all key supervisory objectives, the supervisory plan should also be individually tailored for each banking organization to reflect its particular organizational and operational structure, as well as, where appropriate, the activities of other

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ILCs should be tailored on a case-by-case risk-based basis, informed by the particular business plan and the facts and circumstances of the bank and organization in question. Whether the ownership is "commercial" or financial is not in itself a relevant consideration.

A key element in this equation is the nature of the bank-parent relationship—their relative sizes, the degree of integration, nature and source of funding. The Fed's approach is based on the historical and structural fact that in a bank holding company an insured bank is at the center of the organization and typically the largest (often by far) entity in the BHC. The typical BHC thus contrasts with the diversified financial and nonfinancial companies that control ILCs. Even the handful of largest, multi-billion dollar ILCs are not core entities within the context of the overall financial organizations of which they are a part. The contrast with nonfinancial organizations is even greater, because the degree of integration with affiliates is typically far less than in BHCs or other predominantly financial organizations, with the result that the potential adverse effects on the bank affiliate in a predominantly nonfinancial organization may be more indirect (e.g. reputational) than in an organization in which the bank is more integrally connected to the core financial business of the organization as a whole.

THE BHC ACT PROVISION IS CLEAR AND UNAMBIGUOUS PERMITTING ILC-COMMERCIAL AFFILIATIONS. We believe that it is important to restate and highlight the law with respect to affiliations between ILCs and commercial firms. The BHC Act clearly allows any type of company to control an ILC without becoming a BHC and sets forth the only requirements that should be applied to that type of relationship. The FDIC has no legal authority to impose any restriction based solely on the fact of commercial-ILC affiliation, and can impose no restriction unless it is well grounded in facts relating to safety-and-soundness or other statutory factors.

We believe it is important to be clear as to existing law with respect to these affiliations. Critics who use "loophole" rhetoric to suggest otherwise are simply ignoring what the law plainly provides.

Appendix 1 is a detailed legislative history of the BHC Act ILC provision that leads to the following conclusions: (1) The provision in the BHC Act adopted in 1987 by its terms allows any type of company, including "commercial" firms, to control ILCs going forward, subject only to the requirements of that provision, without becoming a BHC; under normal rules of statutory construction Congress is presumed to intend the results provided under the plain terms of the laws it enacts. (2) In 1999 in the Gramm-Leach-Bliley Act ("GLB Act") even while Congress decided to prevent the establishment of new unitary S&L holding companies controlled by commercial firms going forward, it amended the ILC provision in the BHC Act. Under standard rules of statutory construction, that GLB Act amendment represents a reaffirmation of

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principal or functional supervisors." Risk-Focused Supervision of Large Complex Banking Organizations, SR 99-15 (June 23, 1999). *See* the description of the FDIC Large Insured Depository Institution ("LIDI") Program, Appendix 2, which addresses both ongoing exams where the bank predominates in the organization and those in which the bank does not.

the BHC Act provision for ILCs and thus an expression of Congressional intent to continue the opportunity for commercial firms to acquire or establish ILCs.

Accordingly, even while the GLB Act modified the federal policy concerning affiliations between "banking" and "commerce" by preventing new thrift-commercial affiliations,[30] that Act expressly reaffirmed and even liberalized the pertinent BHC Act provision relating to ILCs. There is no provision or policy in the GLB Act that states that a commercial company ought not control an industrial bank according to the terms of the BHC Act ILC provision. Any contrary suggestion is plainly wrong. In the face of this legislative action in 1999, there is no legal basis to argue that the FDIC should adopt a general restriction on commercial ownership of ILCs.[31] Moreover, we believe it wise policy to continue to allow ILC organizations to continue to be a source of innovation and strength for our nation's financial system.

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?

Response: We do not believe ILCs pose any special risks and that "consolidated supervision" does not represent a distinct variable with respect to risk, as some ILC critics have asserted.[32]

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[30] The ability of hundreds of existing "unitary" S&L holding companies to establish new commercial affiliations was expressly grandfathered—further evidence that Congress drew lines carefully in the GLB Act.

[31] The FDIC does have authority to deny and should deny any particular application involving such a relationship if it fails to satisfy the statutory criteria at 12 U.S.C. § 1816. *See Western Bancorp, supra*.

[32] The assertion of ILC (and FDIC) critics that "consolidated supervision" (as applied under the BHC Act) is necessary for ILC organizations is confusing and misleading. The Request correctly recognizes that there is more than one form of "consolidated supervision." We believe the criticisms of existing ILC supervision have been carefully crafted to give the impression that existing FDIC *authority* is inadequate, with the added, but often unstated, implication that FDIC *performance* as a supervisor also is in some way lacking. As we demonstrate in detail in Appendix 2, the critics' assertion is far off the mark. The critics begin with the implicit position that "consolidated supervision" is only the type of holding company supervision implemented by the Fed, then describe FDIC authority using a very narrow reading of the FDI Act, which ignores both the scope of the FDIC's statutory discretion and its ability to supplement all its statutory supervisory powers with statutory "incidental" powers, and conclude that the FDIC supervision authority is inferior to Fed

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Risk arises from the nature of a business plan and the conduct of activities, and supervision is a means for assessing risk management and not a distinct source of risk (although insufficient supervision can allow institutions risks to go unmanaged[33]). Congress has established three statutory approaches to providing full and effective supervision of depository institutions and their affiliates (and the SEC now does so as well under its distinct regime). Under these statutes, every depository organization will be subject to a supervisory regime that is comprehensive and fully effective, whether the supervisor is the Fed, OTS, or the FDIC.[34] In short, we believe that labels are of no consequence, that the FDIC has all necessary authority and has in place supervisory programs that provide comprehensive and effective supervision of ILC organizations.

We believe it relevant to consider two further points, which are included at the end of the response to this question: the robust Utah authority for regulating and supervising companies that control Utah ILCs; and the extent to which the incidence of bank failures suggests the effectiveness of regulation and supervision.[35]

THE FDIC PROVIDES COMPREHENSIVE AND EFFECTIVE SUPERVISION OF ILC ORGANIZATIONS. As set forth more fully in Appendix 2, it is clear that the FDIC has ample tools to provide effective and appropriate federal supervision of an ILC, its owner, and other

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supervision. *See e.g.*, the testimony of the GAO and Independent Community Bankers Association at the July 2006 House Financial Services Subcommittee hearing. http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=487&comm=3. This argument is circular in nature.

[33] The experience of the banking agencies in the 1980s is instructive. *See* Fed. Deposit Ins. Corp., 1 *History of the Eighties – Lessons for the Future* (December 1997) ("*History of the Eighties*") at #38-79.

[34] The three categories listed in the second subquestion appear to equate "consolidated supervision" with Fed supervision (and perhaps OTS supervision) and thus are categories of limited analytical utility. In particular, in view of the nature and effectiveness of FDIC supervision as discussed below and in Appendix 2, we believe that the categories of institutions that are "not currently subject to some form of consolidated Federal supervision" or "cannot qualify for some form of consolidated Federal supervision" are effectively null sets under current American law.

[35] We note that the 2005 GAO Report considered this question relevant. Government Accountability Office, INDUSTRIAL LOAN CORPORATIONS: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority (September 2005), http://www.gao.gov/new.items/d05621.pdf.

affiliates.[36] The FDIC has the same broad supervisory, regulatory and enforcement authority over industrial banks that it has over other non-member insured state banks under its jurisdiction.[37] In addition, the FDIC has substantial statutory authority to examine and take enforcement and remedial action against affiliates, as may be necessary to protect an industrial bank from adverse affiliate actions.[38] In view of the FDIC's long track record of successful supervision of ILC organizations, it should be immaterial what label is applied.

Whether as a starting point supervision is termed "bank centric" or "consolidated," the banking agencies, and now the SEC, have each demonstrated an ability to design approaches to the problem of effective supervision and oversight which address all the risks posed to safety and soundness, to the Deposit Insurance Fund and to the financial system as a whole by a particular institution and does so in a manner that is appropriately tailored to the specific circumstances presented by this institution.[39]

In Appendix 2 we review the detailed existing FDIC examination policies for supervising affiliates of insured banks, including ILCs, both under its general examination regime and the LIDI Program.[40] This appendix then reviews the standards concerning consolidated supervision

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[36] The Appendix includes excerpts from the FDIC Risk Management Manual of Examination Policies ("Exam Manual") concerning the supervision of affiliates and its LIDI Program.

[37] 12 U.S.C. § 1820(b)(2). The FDIC has addressed in detail the effectiveness of its supervision of industrial banks and in 2004, adopted modifications to improve supervision. Mindy West, "The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective," in *Supervisory Insights* at 9-10 (Summer 2004).

[38] 12 U.S.C. § 1820(b). The FDIC has express power "to make such examinations of the affairs of an affiliate of a depository institution as may be necessary *to disclose fully* . . . (i) the relationship between such depository institution in any such affiliate; and (ii) the effect of such relationship on the depository institution." 12 U.S.C. §1820(b)(4)(A) (emphasis added). The FDIC can use its cease and desist authority to prevent or stop unsafe and unsound practices, including practices by an affiliate, and has express authority to require affiliates to change their conduct to protect the bank. It can impose temporary or permanent cease-and-desist orders against the bank and its affiliates, civil money penalties against the bank and its affiliates, involuntary termination of insurance, or divestiture. The FDIC has parallel express statutory authority to require that banks adhere to the specific conditions of approval orders. 12 U.S.C. § 1818(b), (c), (d), (e) and (j). These express powers are reinforced and expanded by the FDIC's incidental powers under 12 U.S.C. § 1819(a) Seventh.

[39] As the passage quoted in footnote 27 reflects, the Fed also recognizes supervision should be tailored to the particular organization.

[40] This program is actively used in Utah, as Commissioner Leary recently noted: "Utah is participating with the FDIC in the Large Bank Supervision Program for four industrial banks.

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under the EU Conglomerates Directive and the standards of the Fed when it makes determinations whether non-U.S. banking organizations should be viewed as having home country consolidated supervision. This review of the EU and Fed standards demonstrates that the existing examination and supervision program implements standards and policies are robust by any standard and substantially parallel to those in the EU Directive for nonmember insured banks under its jurisdiction, including ILCs and their affiliates.

We believe that the materials set forth in Appendix 2 demonstrate that the FDIC ***both*** has the authority to provide the equivalent of consolidated supervision over ILC organizations ***and*** has in place a supervisory program that provides that comprehensiveness of supervision for existing ILC organizations whose size and complexity call for such treatment. Critics that suggest that the FDIC has inadequate authority to supervise ILC organizations involving commercial affiliates are simply wrong -- they read the FDI Act in an unduly narrow way, ignore the FDIC's discretion to implement and apply its statute, and take no account of the express statutory authority of the FDIC to use its "incidental" powers under 12 U.S.C. § 1819 to supplement its other powers in order to achieve its mandate to ensure the safety-and-soundness of insured banks and to protect the FDIC fund.

UTAH AUTHORITY OVER PARENT COMPANIES OF ILCS. The Utah Department of Financial Institutions ("DFI") has robust, plenary authority over both its ILCs and companies that control them.[41] The Commissioner of the DFI has broad supervisory regulatory and enforcement authority over Utah ILCs that is parallel to the FDIC's authority. Such authority includes the right to examine the ILC and to take enforcement and remedial actions against the bank and its affiliates. *See, e.g.*, Utah Code Ann. §§ 7-1-307, 7-1-308, 7-1-313, 7-1-314, 7-1-501, 7-1-510 and 7-2-1. Enforcement powers include the right to issue cease and desist orders, remove directors and officers, take possession of the institution, and enforce supervisory acquisitions and mergers. *See, e.g.*, Utah Code Ann. §§ 7-1-307, 7-1-308, 7-1-313 and 7-2-1. The Commissioner has authority to impose any conditions and limitations on an application for authority, as necessary to protect depositors, creditors and customers. Utah Code Ann. § 7-1-704.

Furthermore, corporations and other business entities that control an ILC, as well as the subsidiaries and affiliates of such entities, are subject to Utah Code Ann. § 7-1-501. The Commissioner thus has direct supervisory authority over all ILC holding companies, and may take enforcement and remedial actions directly against the holding company and its affiliates as necessary. *See, e.g.*, Utah Code Ann. §§ 7-1-307, 7-1-308, 7-1-313, 7-1-314, 7-1-501, 7-1-510

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The supervision of these large banks is coordinated by a fulltime relationship manger for the State as well as the FDIC. These examiners coordinate the implementation of the supervisory plan for each bank. This plan generally involves three targeted reviews that roll-up to an annual Examination Report that is reviewed with management and the board." http://www.dfi.utah.gov/PDFiles/IB%20Speech%202006.pdf.

[41] *See generally* http://www.dfi.utah.gov/PDFiles/IB%20Speech%202006.pdf.

and 7-2-1. The Commissioner may also adopt rules with respect to ILC holding companies to protect depositors, the public and the financial system of the state. Utah Code Ann. § 7-1-301.

BANKING FAILURES AS A MEASURE OF THE EFFECTIVENESS OF SUPERVISION AND RELATIVE RISK. In view of the focus of Question #3 on risk as related to the nature of supervision, it pertinent to point out that we do not believe that the FDIC has ever suffered a loss due to the failure of an ILC controlled by a commercial firm.

According to the FDIC's Summer 2004 *Supervisory Insights* there were 21 ILC failures between 1985 and 2003, and only four since 1995. None were ILCs controlled by non-financial companies, and the failures occurred due to poor management and judgment with respect to traditional banking activities.[42] This report also points out that there were no industrial bank failures in Utah between 1985 and 2003. This record demonstrates the strong supervisory and regulatory environment for ILCs domiciled in Utah.

Recent history, moreover, demonstrates that the partnership of the FDIC and the DFI in regulating ILCs can effectively protect the bank as well as the insurance fund from the financial problems of its parent. In December of 2002, Conseco, Inc. and Conseco Financial Corporation filed for bankruptcy. At the time of the filing, Conseco was the parent of Conseco Bank, a Utah ILC with approximately $3 billion in assets. Because of the bank's independence from its parent (as mandated by regulation) and the regulatory supervision provided by the FDIC and the DFI, the safety and soundness of the ILC was never impacted or even questioned. In fact, the ILC was sold by Conseco to GE Capital for $323 million which was equal to the book value of the ILC at year-end 2002.[43]

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[42] *Supervisory Insights*, *supra* note 2 at 6, 11. In its July testimony, the Fed indicated that an insured ILC failed in 1999 at least in part due to "the *inability* of any federal supervisor to ensure that the parent holding company remained financially strong." (emphasis added). The FDIC, as discussed above, has authority to ensure that affiliate transactions do not adversely affect an insured bank and to require the parent to serve as a source of strength. However, no banking agency can enhance the ability of a parent to raise capital in the capital markets. The BHCs that failed in the late 1980s and early 1990s did not fail because the Fed was "unable" to seek to have the parent serve as a source of strength, but because the parent was unable to remain financially strong. This is, of course, greatly exacerbated when the troubled bank is the predominant entity in the corporate family. *See generally History of the Eighties*, esp. chapter 4. We do note that the Fed's authority to impose consolidated holding company requirements is not expressly stated in the BHC Act and that the Supreme Court has questioned the basis for the Fed to implement its "source of strength" doctrine. *See Board of Governors v. MCorp*, 502 U.S. 32 (1991)

[43] S*ee* "The Example of Conseco," http://www.fdic.gov/bank/analytical/banking/2005jan/article3.html. The track record of other commercial-banking affiliations also has been very strong. During the late 1980's and early 1990's when there were widespread bank and thrift failures, only a handful of thrifts

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This experience speaks directly to commentators who expressed concern about what would happen to the FDIC fund if an ILC's parent were forced to file bankruptcy. The inaccurate underlying assumption of the comments is that the FDIC and the Utah Department of Financial Institutions lack sufficient authority and oversight to protect safety-and-soundness of the bank, depositors, the FDIC fund, and the financial system generally.

More broadly, we believe that the experience with respect to banking failures underscores the Conseco example. The fact is, the largest and most costly failures to the FDIC fund have been banks controlled by registered bank holding companies.[44] These facts certainly suggest that there is no substance to the argument that the consolidated supervision under the BHC Act approach provides greater protection to the FDIC fund than the FDIC's or the OTS's unitary holding company supervisory approach to supervision of insured depository institutions owned by commercial or diversified financial companies.

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?

Response: Applicable statutes set forth the factors to be considered by the FDIC when considering notices and applications and provide the FDIC considerable discretion in the implementation of those statutory requirements. Under existing case law,[45] however, the FDIC cannot give weight to considerations that are not encompassed by the statutory factors.

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held in a unitary holding company by a diversified financial or commercial company failed. At the same time, commercial and diversified financial companies acquired a number of failed thrifts and brought substantial new capital to the thrift industry. *See* L. White, *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation*, (New York: Oxford Univ. Press, 1991), esp. pp. 216 n.17, 228 n.27, 240-43. Finally, we would note that in the early 1980's, Baldwin-United, an insurance holding company with commercial affiliates and a bank affiliate, failed and went into an insurance insolvency proceeding. Despite this failure, the insured bank controlled by Baldwin-United was not adversely effected and was sold intact without any loss to the FDIC fund. *See generally History of the Eighties*, esp. chapter 4.

44 Continental Illinois Corp., First Republic Corp., MCorp, First City Bancorporation, Bank of New England Corp., Southeast Bancorp. *Id.* at 245 n.37. The powers of the Fed as the consolidated supervisor of bank holding companies at the times of these failures were essentially the same then as they are now. The fundamental point is that effective supervision is about substance, not form, and any suggestion that the FDIC cannot, and does not, provide comprehensive and effective supervision on a par with the other federal banking agencies is not based on the factual record.

45 *See Western Bancshares, Inc. v. Board of Governors*, 480 F.2d 749, 750 (10th Cir. 1973).

The FDIC reviews and decides applications for insurance for a de novo institution to be controlled by a nonbanking company and reviews notices by such companies under the Change in Bank Control Act (CBCA).[46] As set forth in its policies and manuals,[47] the FDIC has consistently focused on the appropriateness of the prospective parent or acquirer from the perspective of:

- its financial strength and ability to provide ongoing financial and other support to the depository institution;[48]
- the quality and character of its management;[49]
- its record of performance and integrity;[50]
- its systems and controls as they may relate to the bank;[51] and
- risk presented to the FDIC fund.[52]

There is no basis for the proposition that the FDIC should change its established (and successful) practices with respect to applications. The institutions approved or permitted by the FDIC in these many past applications have operated in a safe and sound manner and none controlled by a "commercial" company has failed.[53]

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46 The 2006 FDIC OIG Report indicates how effective the FDIC has been and continues to be in reviewing and deciding applications. *See generally* http://www.fdicig.gov/reports06/06-014.pdf

47 *See* generally FDIC Statement of Policy on Applications for Deposit Insurance; Case Manager Procedures Manual ("CMPM") at 21—2, 9-10, 17-19. In its 2006 report, the FDIC OIG explicitly addresses both this overall fact and the elements of the FDIC's applications review discussed below; *see* Report at pp 4-8.

48 *See* CMPM at 21-9, 21-18.

49 *See* CMPM at 21-19.

50 *See* CMPM at 21-12.

51 *See* FFIEC Information Technology Examination Handbook, http://www.ffiec.gov/ffiecinfobase/html_pages/it_01.html.

52 *See* 12 U.S.C. §§ 1816(5), 1817(j)(7)(F).

53 *See generally* 2006 FDIC/OIG Report, http://www.fdicig.gov/reports06/06-014.pdf; and the 2005 GAO report, *supra*, pp. 57-61.

The FDIC has authority to "require such additional information as is necessary to fully evaluate" an application or notice, including information about the bank's parents and affiliates.[54] The statutory factors to be considered in connection with CBCA transactions[55] and insurance applications[56] are parallel. The CBCA factors specifically address the nature, capacity and prospects of the acquiring party and the possibility of adverse effects on the Deposit Insurance Fund, and the FDIC review of financial, managerial, and risk factors in insurance applications involves the same considerations. In short, the FDIC's ability under its existing statutory authority to assess any and all risks associated with an application, including those that may arise from the parent or acquirer, are broad, open-ended and enforceable.

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?

Response: We do not believe the law allows addition to or subtraction from the statutory factors, which are, of course, quite broad and include an assessment of risks to the Deposit Insurance Fund.[57] These factors give no weight to the type of business of the parent. And of course they are applied on a case-by-case basis in the context of each particular application or notice.

Consistent with a case-by-case approach, we believe the FDIC should assure itself of the financial strength, the quality and character of management, its ability to obtain information and cooperation from management, the potential interaction and relationship, if any, with aspects of the parent's business and any other factors which bear on the health and prospects of the depository institution.

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54 CMPM at 20.1-10. *See also* CMPM at 21—16-20. If an applicant refuses to provide requested information, the application or notice will be deemed abandoned by the applicant. *See* 12 C.F.R. § 303.11(e); CMPM at 21-2. Under the CBCA, a notice may be rejected if the acquiring person fails to provide requested information. *See* 12 U.S.C. § 1817(j)(7)(E).

55 *See* 12 U.S.C. 1817(j).

56 *See* 12 U.S.C. 1816.

57 The courts have made it plain that banking applications must be judged based only on statutory factors. *See Western Bancshares, Inc. v. Board of Governors*, 480 F.2d 749, 750 (10th Cir. 1973). "Banking and commerce" is not an element of any statutory factor and may not be an element, implicitly or explicitly, in an FDIC decision on a change in control notice or application for deposit insurance. *See* pp. 16-18, *supra*, and Appendix 1.

Thus, the FDIC should have an in-depth understanding and make an in-depth evaluation of the parent consistent with the goals of bank supervision and regulation – including the nature and quality of the parent's business.[58] There is, however, no legal basis on which to discriminate among ILCs on the basis purely of type of business engaged in by the parent.

Arguably, the FDIC could consider as a positive or negative factor the quality of any regulation and supervision that may be provided by other regulatory agencies with respect to the parent or other affiliate. Of course, in the case of the commercial or industrial parent of an ILC, the federal agency with that authority and responsibility is the FDIC itself. Both the FDIC Exam Manual generally, and the FDIC's LIDI Program in particular, demonstrate that the FDIC is already exercising supervisory powers as appropriate to the specific situation.[59] In addition, the FDIC can consider the authority and track record of the DFI with respect to ILC organizations.[60] However, we believe the absence or presence of a particular approach to consolidated supervision should not be determinative of the outcome of an application.

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?

Response. No. We know of no basis for imposing across the board the types of restrictions listed in the question. We believe any restrictions or requirements imposed on applicants by the FDIC must be based on findings that support such an imposition and be well grounded in the FDI Act. Case-by-case conditions that address particular aspects of an application have proven to be an effective tool.

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58 The FDIC's broad authority and established practices for evaluating applications and notices with respect to both the depository institution and the prospective parent are discussed and documented in our response to question #4.

59 *See* CMPM, ch. 11.

60 *See* text at pp. 21-22, *supra*, for a summary of the Utah Department's powers. The Department's standards and practices have been frequently discussed by its Commissioner, including recently in testimony before the House Subcommittee on Financial Institutions, July 12, 2006, http://www.dfi.utah.gov/PDFiles/IB%20Congressional%20Testimony%20-%20ELeary.pdf. *See* also http://www.dfi.utah.gov/PDFiles/IB%20Speech%202006.pdf.

THE FDIC'S EXISTING APPLICATIONS REVIEW PROCESS AND USE OF CONDITIONS ARE COMPLETE, EFFECTIVE, AND APPROPRIATE. As found by the FDIC OIG in its July 2006 report, the FDIC's current practice includes the use of a list of "standard" conditions used in all applications, a list of "nonstandard" conditions, some or all of which may be used when appropriate in particular approval orders, and "prudential" conditions that are tailored case-by-case.[61] The range and scope of these conditions have evolved over time[62] and reflect the FDIC's well-established approach to using conditions as a means for providing tailored supervisory standards and other requirements on a case-by-case basis. In view of the express statutory authority to enforce such conditions (as well as other "written agreements") and to impose penalties for noncompliance, we believe conditions are plainly a potent and effective supervisory tool.[63] The FDIC's practices with respect to conditions provides both a relative consistency for addressing similar issues presented in various applications and the flexibility to address individual applications as its deems appropriate.

The existing standard and optional conditions currently used by the FDIC have been developed over time and appear appropriate and workable. Additional conditions have been added on a case-by-case basis, and the FDIC has broad discretion to impose specific, tailored conditions based upon the facts and circumstances of a particular application. The existing list of standard and optional conditions has been developed based on supervisory and safety-and-soundness considerations or implements specific statutory requirements. General limitations not related to the specific application before it and not flowing from the statutory factors would limit the business flexibility of insured ILCs or banks and could adversely and inappropriately affect their competitiveness. Adoption of new standard conditions for ILC applications imposing such competitive limitations would be inappropriate.

We believe that non-standard conditions, prudential conditions or any other special conditions should be placed on a category of institutions or applicants if, and only if, there is a well-supported finding that that category consistently presents a particular circumstance common to the entire category and that is not present for other types of depository institutions. We know of no basis for adoption of any such conditions that would pertain to all ILCs or even any particular category of ILCs, as opposed to conditions that may arise from the facts and circumstances of a particular applicant.[64]

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61 2006 FDIC OIG Report , *supra*, at 36. 37. 39, 41.

62 *E.g.*, in 2004 in connection with the IG Report, the DSCP gave specific consideration to the standard and nonstandard conditions for ILC applications that would be used when appropriate to a particular application. *See* Memorandum from Director Zamorski to Regional Directors, March 12, 2004 (Transmittal 2004-011).

63 *See* 12 U.S.C. § 1818(b), (e), (j); 2006 FDIC OIG Report, *supra*, at 10-16.

64 The FDIC's practice is to "impose significant restrictions on new ILCs before they receive deposit insurance. Depending on the purpose and placement of the bank within the

[Footnote continued on next page]

THE FDIC HAS SPECIFICALLY CONSIDERED THE TYPES OF CONDITIONS APPROPRIATE FOR ILC APPLICATIONS. At the time of the 2004 FDIC OIG report, the FDIC reviewed its application and examination procedures and expanded the list of conditions that would be expected in ILC acquisitions. In addition, the FDIC has directed that ILC organizations be supervised under the FDIC's LIDI Program when appropriate. As found in the 2006 FDIC OIG Report, the FDIC's established approach to reviewing applications and imposing and monitoring conditions after approval has been effective. There is no basis for the FDIC to change its approach.

A STATEMENT OF POLICY OR RULE MAY MAKE CLEARER THE FDIC'S APPLICATIONS AND SUPERVISORY POLICIES AND PRACTICES IN CERTAIN RESPECTS. To date, the FDIC has proceeded effectively by orders with conditions in connection with applications, but always has the ability to adopt a general rule if deems it appropriate to take an across-the-board approach. (It is well established that an order issued by a federal agency has the equivalent legal effect as a regulation and that an agency has discretion to proceed by either order or regulation[65]. We believe that the inescapable conclusion to be drawn from the law and facts addressed by the Request is that the FDIC has all necessary authority and that it has utilized that authority to develop applications and supervisory practices concerning ILCs and affiliates that are practical and effective.

Nevertheless, as suggested above, in view of the apparent lack of understanding among some parties, we do believe it may be useful for the FDIC to adopt rules reiterating its authority and codifying certain existing practices, with such modification as may be appropriate based on responses to the Request and comments received during the rulemaking. Alternatively, the FDIC might adopt a statement of policy.[66]

[Footnote continued from previous page]

organizational structure, mandated safeguards include: on-site management rather than management from distant corporate headquarters, independent boards of directors, strict guidelines to ensure arms-length transactions with the parent and other affiliates, and so on." CSBS Remarks, *supra*. We note that Wal-Mart has voluntarily agreed to accept certain conditions to approval of its application, including one restricting all branching. We note that such a voluntary agreement included in an order also is enforceable by its terms, as a "written agreement," even if it is not a condition that the FDIC would have authority to impose unilaterally on an applicant. *See* 12 U.S.C. § 1818(b), (c), (d), (e) and (j).

65 *See SEC v. Chenery*, 332 U. S. 194 (1947).

66 Note that such an approach would be similar to the approach followed by the FDIC in the 1980s with respect to securities affiliates of insured banks. In 1982, the FDIC adopted a Statement Of Policy On The Applicability Of The Glass-Steagall Act To Securities Activities Of Subsidiaries Of Insured Nonmember Banks, *47 Fed. Reg. 38984* (September 3, 1982) and subsequently adopted safety-and-soundness rules addressing such affiliations, *See* 12 C.F.R. § 337.4. *See ICI v. FDIC*, 815 F.2d 1540 D.C. Cir. 1987).

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?

Response: Yes to the first question, and no to the second question. The FDIC and other banking agencies have a long and successful practice of using conditions to applications to address particular issues and concerns posed by a specific application. Such conditions, together with the FDIC's overall supervisory program, have proven highly effective in promoting safety-and-soundness and protecting the Deposit Insurance Fund, whatever the nature of the activities in which the bank's parent or affiliates engage. Any general restriction on ILC affiliations with commercial organizations based on safety-and-soundness considerations must be well supported by both factual findings and the law. We do not believe any such support exists.

FDIC'S USE OF CONDITIONS IS EFFECTIVE. As discussed in response to Question #6, the FDIC's established practices with respect to use of conditions is flexible and demonstrably effective. The 2006 FDIC OIG Report conclusion on the effectiveness of the existing FDIC approach to the use of conditions in ILC applications (with minor suggested improvements) speaks for itself.[67] Conditions are effective because a violation of a condition to an approval is a basis for sanctions under Section 8 of the FDI Act.[68]

Moreover, ILCs as a category pose no special or unusual problems, regardless of the activities of the parent or affiliates of the ILC. Accordingly, there is no basis whatsoever for adoption of new safety-and-soundness requirements directed only at ILCs as a category or to restrict the types of entities that can control an ILC. As set forth above, conditions and supervision are most effective when they are tailored on a case-by-case basis. The appropriateness of a particular approach or set of non-standard conditions depends upon the specific matter before the agency rather than whether the company is predominantly commercial or financial.[69]

THERE IS NO BASIS FOR LIMITING ILC AFFILIATIONS TO FINANCIAL FIRMS. The principal question in the *Mandate for Change* study was whether federal law should continue to limit the activities of affiliates of insured banks. That analysis concluded that all such restrictions should be repealed: "The major conclusion of this study is that insulation [of insured banks from their affiliates] 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

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[67] *See* 2006 FDIC OIG report, *supra*, "Results of Evaluation."

[68] *See* 12 U.S.C. § 1818(e)(1)(A)(iii).

[69] The Wal-Mart application illustrates how conditions and commitments can be adapted to meet specific conditions. In our case, we have voluntarily committed to a no branching restriction.

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 Act restrictions on affiliations between commercial and investment banking firms should be abolished."[70]

In view of the express authorization of ILC-commercial affiliations in Section 2© of the BHC Act, the FDIC must have a strong factual basis before adopting any general restriction of nonfinancial affiliations for ILCs based on safety-and-soundness.[71] None has yet been advanced by any ILC critic and we believe it is not possible to make such a finding based on evidence.

Such an across-the-board approach would also be unwarranted because the FDIC has authority to impose any condition relating to safety-and-soundness or risk to the Deposit Insurance Fund that it deems necessary, on a case-by-case basis based upon appropriate findings. If justified by the facts of a particular case, conditions can be stringent and long-lasting.[72] The FDIC routinely imposes conditions on applications (including ILC applications) that provide the FDIC with ongoing supervisory tools and authorities tailored to each application. The FDIC has specific statutory authority giving it a number of tools to enforce such conditions and to take actions against a bank or affiliate that does not observe them.[73]

We do not believe the FDIC has authority to generally bar *all* nonfinancial companies from acquiring or establishing an insured ILC on safety-and-soundness grounds. We note that when the Fed attempted to restrict nonbank banks by redefining statutory terms in its rules, a unanimous Supreme Court in the *Dimension* case held that it had exceeded its authority.[74]

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[70] *Mandate for Change, supra*, at 101-02 (emphasis in original). The 1991 Treasury Report and the 2005 Restructuring Report each concur with the FDIC's findings in *Mandate for Change*. *See* text accompanying footnotes 105-109, *infra*.

[71] *See* Appendix 2.

[72] The 2006 FDIC OIG Report, *supra*, discusses such ongoing conditions at 13-15, 30. On March 12, 2004, the Division of Supervision and Consumer Protection issued a memorandum entitled "Imposition of Prudential Conditions in Approvals of Applications for Deposit Insurance." That memorandum states: "Applicants should also understand that certain prudential conditions may be imposed well beyond the institution's initial three year period of operation."

[73] *See* 12 U.S.C.§ 1818(a),(b),(c), (j)(2), (u)(1)&(3) (including cease-and-desist and civil money penalty authority).

[74] *See generally Board of Governors v. Dimension Fin'l Corp.*, 474 U.S. 361 (1986) ("*Dimension*"), discussed in footnote 111 and accompanying text, *infra*.

Finally, the system benefits from the resources nonfinancial firms can bring to the system. During the thrift crisis, commercial entities served as a source of strength and capital to the system and the deposit insurance funds at a time in which the financial sector was weakened.[75] Indeed, the FDIC should consider the consequences of denying itself access to the resources of nonfinancial companies, which have been in the past and remain an important safety net for times of crisis.

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?

Response: We do not believe any such greater likelihood exists.

We note that this question arises from the unsupported premise asserted by critics of ILCs (and indirectly of the FDIC) that the FDIC and DFI lack authority and capacity to supervise an ILC and its affiliates; the premise ignores their effectiveness for over two decades.

Critics also ignore the long history of regulatory experience with affiliations between nonfinancial companies and insured depository institutions (e.g., nonbank banks and unitary S&LHCs), a history that shows no evidence of greater likelihood of conflicts of interest or tying involving such types of firms.[76] There is no factual basis to support the view that conflicts of interest are more likely with nonfinancial affiliates. Indeed, the types of examples often cited involve conflicts involving financial affiliates. For example, the 2005 Blair study refers to the

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[75] *See* L. White, *The S&L Debacle* (1991), at 242.

[76] The CSBS Remarks, *supra*, note not only the effectiveness of both existing law and FDIC supervisory practices, but also the fact that the FDIC has "found parent companies of ILCs to be acutely conscious of their responsibilities with respect to their ILC subsidiaries and the consequences of violating applicable laws and regulations." These observations are consistent with the analysis of the *Mandate for Change* study, which addressed six types of potential conflicts of interest and concluded: "Despite the widespread potential for abuse, there is little to suggest that conflict-of-interest abuse in the U.S. economy is at an unacceptable level. Those who make such claims bear the burden of proof, but they have presented no such proof. . . . Without evidence to the contrary, one must conclude that existing controls are adequate to prevent excessive conflict-of interest abuse. Nowhere is this more true than in the banking industry." *Id.* at 46. The findings and recommendations of both the 1991 Treasury Report and the 2005 Restructuring Report are consistent with the *Mandate* analysis. *See* footnotes 102 & 105, *infra*.

possibility that if a bank borrower were in distress that jeopardized the ability to repay loans, the parent would have an incentive to have its underwriting affiliate help issue bonds for the customer so that the proceeds could pay off the loan. Another example cited was the 2003 enforcement actions brought by the SEC against investment banking firms that were promoting securities of firms that their research departments knew were in trouble.[77] This study concludes: "On examination, the principal potential conflicts that are offered as a rationale for separating banking and commerce seem unlikely to pose significant risks to the safety and soundness of the bank or to the federal safety net. . . . In short, . . . most conflict situations affecting banks can be controlled through the supervisory process and enforcement of the appropriate firewalls and need not pose excessive risk to banks or the banking system."[78]

The legal safeguards against affiliate abuse apply across the board to all insured banks and thrifts—Sections 23A & 23B, the antitying rules and the insider lending rules. Sections 23A and 23B and existing antitying rules, supplemented by the examination process, have proven effective. In view of the lack of actual problems over many years of ILC and nonbank bank affiliations with "commercial" firms, and the rigor of the examination process combined with the potential of the agencies' enforcement tools, critics should have the burden of demonstrating that the safeguards are inadequate.

In the 1980s and 1990s, there was extensive consideration by the regulatory agencies, the academic community and in Congress of the potential for conflicts of interests and tying if a bank were permitted to be affiliated with a nonbank financial firm such as an investment bank, broker-dealer, or insurance company, which were regarded as "commercial" entities prior to enactment of the GLB Act.[79] Rules and guidance (*e.g.*, regarding Section 20 affiliates, guidelines for retail sales of nondeposit products by banks, sales of insurance products by depository institutions and affiliates) were developed to address these concerns and have helped to inform best practices in parallel contexts.[80] The rules concerning tying also were given

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[77] 2005 Banking-Commerce Study, *supra*, at 6. This study cites no example of conflicts of interest that are unique to bank-commercial affiliations.

[78] *Id.* at 7.

[79] *See, e.g.*, 1991 Treasury Report at XVIII--29-31.

[80] Agency Transaction Services for Customer Investments (Securities Brokerage), *BHC Supervision Manual* Section 3230.0; Underwriting and Dealing in U.S. Obligations, Municipal Securities, and Money Market Instruments *BHC Supervision Manual* Section 3240.0; Interagency Statement On Retail Sales Of Nondeposit Investment Products, adopted by each of the four banking agencies. *See* OCC Banking Circular 274 (July 19, 1993), FDIC Supervisory Statement FIL-71-93 (October 8, 1993), former Federal Reserve letters SR-93-35 (June 17, 1993) and SR-91-14 (June 6, 1991), and OTS Thrift Bulletin 23-1 (Sept. 7, 1993).;12 C.F.R. Part 343—Consumer Protection In Sales Of Insurance, implementing 12 U.S.C. 1831x.

careful review and were modified to permit appropriate product bundling.[81] There is no evidence that the incidence of bad practices is greater in the nonfinancial organizations than financial firms.[82]

Conditions to an application approval are effective for dealing with the potential for conflicts arising in the context of a particular business plan and are very effective.[83] Violations of conditions are a basis for sanctions under Section 8 of the FDI Act.[84]

Given the extensive experience over decades, it seems unlikely that any significant new type of risk would emerge, but as in the past the FDIC has all the authority it needs and can determine whether to proceed case-by-case or to amend its rules. Here again, we believe the burden should be on the critics to come forward with facts demonstrating actual problems.

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?

Response: After decades of experience with nonfinancial affiliations, there is no factual basis to support the view that there are competitive advantages that are based upon a particular pattern of affiliation or ownership. Indeed, some nonfinancial firms have entered the field with much fanfare and high expectations only to achieve less than spectacular results (and later withdraw).

EXISTING REGULATORY POLICIES SEEK TO PROMOTE AN OPEN AND COMPETITIVE BANKING SYSTEM. The FDIC and the other banking agencies have for more than two decades considered the competitive environment from two perspectives. First, the "convenience and needs" factor has been applied to give positive weight to applications which increase competition. Second, the agencies have evaluated whether the applicant has appropriately taken into account the competitive environment in devising its business plan.

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81 *See generally BHC Supervision Manual* Section 3500.

82 *See* 2005 Banking-Commerce Study at 6.; *Mandate for Change* at 49-51 ("Evidence has not been presented that abusive tie-ins are any more likely to occur in banking organizations than in other types of business organizations."[51]) and 90 (evidence from existing relationships betweens banks and commercial firms, *e.g.* , a community bank and auto dealer controlled by the same person, have not resulted in excessive abuse; such relationships can be addressed by supervision, without new rules).

83 *See* CSBS Remarks, *supra*.

84 *See* 12 U.S.C, § 1818(b)(1), (e)(1), (i)(2)(A)(iii).

It has been nearly three decades since the banking agencies sought to protect existing competitors from competitors with greater financial strength or size or a new idea. To suggest that such an approach be revived would not be appropriate and would reverse three decades of consistent public policy.

Moreover, evidence and academic analysis support the conclusion that our banking system is competitive and without significant barriers to entry. The 2005 Bank-Commerce study states that if size confers competitive advantage, then the possibility of adverse effects are similar whether the large competitor is a commercial firm's bank affiliate or a banking organization. This statement is supported by academic analysis concluding that there is no reason to believe that elimination of the banking-commerce separation would adversely effect competition in banking and that "[i]ndeed, it may be that such a policy could have pro-competitive effect, as the number of potential entrants and potential competition expands."[85]

The statutory requirements involving antitrust considerations provide the legal basis for considering "fair competition" and the criteria for considering competitive effects.[86] As has been the general policy of the banking agencies for many years, the FDIC should permit institutions that meet the legal criteria and that operate according to regulatory norms to compete vigorously in the marketplace. Economic efficiency and consumer interests are best served by that approach.[87]

"FAIR COMPETITION" IS A MASK FOR PROTECTIONISM. "Fair competition" has been advanced by ILC critics as a reason for limiting commercial-ILC affiliations.[88] Properly run banks of all types have thrived during the last 15 years, a time of monumental change in banking and financial services. It is true that the number and sizes of ILCs have grown over this

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[85] 2005 Banking-Commerce Study at 7-8, quoting Saunders, Banking and Commerce: An Overview of the Public Policy Issues, *Journal of Banking and Finance* (1994) 18:231-54, at 239.

[86] *See* 12 U.S.C. § 1816.

[87] *See* 1991 Treasury Report at XVIII—32.

[88] As a former community banker, Chairman Powell commented on competitive concerns: "Many worry about competition in the future that may come from new entrants into the ILC environment. I understand these fears. After all, I was a community banker once and I know all too well the pressures these institutions feel every day. * * * [W]hile I understand the anxiety some people have on this issue, fear of competition should not be the compelling argument in formulating good public policy." CSBS Remarks, *supra.*

period, but as noted in the response to question #1, they represent only about 1.5% of all banking assets and can hardly be viewed, in general, as a competitive threat to any bank, large or small.[89]

Moreover, the most significant competitive changes over this period have occurred as a result of the enactment of the historic and far-reaching Riegle-Neal interstate branching statute in 1994 and the ability of banks to enter new interstate geographic markets. A parallel development has been the adoption of more detailed and explicit rules for national banks (and federal thrifts) with respect to the preemption of state law for these federal institutions. Simultaneously, the effects of computer technology, telecommunications, and the Internet have made fundamental changes in how financial business is conducted. Each of these changes is unprecedented and in many respects revolutionary. Cumulatively, they have been transformational.

During this period of revolutionary change, the banking industry as a whole and soundly managed banks of all sizes have demonstrated that competition in banking is vigorous and good for them and their customers. In light of these developments and this history, the call for "fair competition" with respect to ILC organization seems makeweight and is certainly ironic in light of the argument that lasted for more than 20 years preceding the enactment of the GLB Act. We believe that when viewed objectively, the call for "fair competition" seems to be little more than a mask for protectionism.

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?

Response: Yes, consumers do benefit from the innovations and products and services that banking affiliates of "commercial" firms have provided during the last two decades. ILC organizations have a strong track record of providing financial and other support to their communities and exemplary CRA records. We believe it is appropriate for the FDIC to consider these benefits when considering applications.

PUBLIC BENEFITS RESULT FROM EXPANDED PRODUCTS AND SERVICES. The FDIC has recognized since at least *Mandate for Change* that commercial affiliations bring the benefits of healthy competition and expanded, and often innovative, products and services.[90] Such benefits can be considered under the "convenience and needs" factor in 12 U.S.C. § 1816. We believe that ILC organizations have demonstrated that they expand the range of products and services in the marketplace—for example, the card products provided a number of ILCs,

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[89] Indeed, Wal-Mart's strategy with respect to in-store banking provides community and some regional banks a platform for reaching customers in more than 1,000 of our stores and thus enhances their ability to compete with the multi-state mega-banks.

[90] *See Mandate for Change* at 2 and chapter 2; 2005 Banking-Commerce Study, *supra*.

products and services of BMW and Volkswagen to their customers, services to niche markets by, *inter alia*, Toyota, Target, Wright Express, Flying J, Medallion, and Harley-Davidson.

We also believe that commercial firms have shown they can expand access to banking and financial services and serve needs not met by more traditional institutions. Such an arrangement can involve both affiliated banks and unaffiliated banks that place banking facilities in commercial stores. As an example, Wal-Mart currently has bank branches of independent community and regional depository institutions in more than 1,000 of its stores.

In addition, nonfinancial companies have demonstrated that they can identify and help serve unmet needs. While these products and services can be provided in conjunction with unaffiliated banks, present law appropriately allows ILC organizations to do so and thus they can be a source of innovation and experimentation.[91]

The kinds of benefits that a nonfinancial company can provide can be concretely illustrated by what Wal-Mart is currently doing through relationships with nonbank partners with which the Wal-Mart Financial Services Division has contractual arrangements to provide money service products and services to customers in Wal-Mart stores. These include low-cost money orders (@ $0.46 each versus $0.75 industry average), payroll check cashing (@ $3.00 versus $6.00 industry average) and international remittances (@ $9.46 versus $15.00 industry average)[92]. These products are used especially by low- and moderate-income customers and ones who are unbanked and underbanked. We estimate that our customers save approximately $3 to $4 million each week by using our products, which means that annual savings may exceed $150 million and may be as much as $200 million each year. These activities do not involve the proposed Wal-Mart Bank and will continue to be provided under existing arrangements.

PUBLIC BENEFITS ARE PROVIDED THROUGH ROBUST CRA PROGRAMS. In addition, many ILC organizations have proved to be leaders in developing robust and effective CRA programs and have provided hundreds of millions of dollars for loans and investment through their CRA activities. The comment dated October 4, 2006, and filed in response to the Request by Diane Hartz Warsoff, Executive Director of the Utah Nonprofits Association makes this point:

> However, there is one aspect of the IB charters that is not being discussed in these comments. Industrial Banks provide significant added-value to the Utah community. IB's are subject to the provisions of the Community Reinvestment Act, and as such, are required to support low- and moderate-income people in our

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[91] While we believe this capability is an important benefit of the existing legal framework, we would repeat our prior unequivocal statements about the narrow focus of the business plan for the proposed Wal-Mart ILC. Nothing in these comments is intended to suggest any alteration of the business plan filed with our FDIC and Utah applications.

[92] Industry averages based on internal estimates, as of May 2006.

communities. Not only do these banks provide below-market rate loans to nonprofit organizations (something that commercial banks have been unwilling to do, making it very difficult for nonprofit organizations to obtain much-needed credit), but the IB's are active participants in our communities—working to improve the lives of the citizens where they are based. In Utah alone, many organizations that serve our most vulnerable populations receive much-needed support to meet their missions and improve lives.

We believe public benefits from ILCs may be concretely illustrated by the CRA plan submitted by Wal-Mart Bank ("the Bank") in its application. As a "wholesale bank" that does not engage in any lending of any kind, the Bank would be evaluated for CRA purposes based upon its community development investments and services and its responsiveness to community development needs in its assessment area. The qualifying community development activities detailed in the CRA Plan include:

1. CRA Qualified Investment Goal of 15% of Assets. The Bank will target a ratio of CRA-related investments to average assets of 15% by the end of its first year of operation—or about $20 million[93]. This investment ratio is far greater than is typical for insured banks.

2. Qualifying Investments. The Bank will endeavor to identify appropriate qualifying investments directly benefiting its assessment area, or the State of Utah, but has no assurance that it will be able to make investments at the projected level within Utah. Accordingly, in keeping with § 345.25(e)(2),[94] the Bank anticipates that it will make qualifying investments outside its assessment area. This extraordinary commitment reflects not only the Bank's commitment to its community, but also the exemplary community support demonstrated by Wal-Mart for many years.

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[93] The Bank's ability to achieve this goal will depend on the availability of qualifying investments that meet safety-and-soundness criteria "(d) *Safe and sound operations.* This part and the CRA do not require a bank to make loans or investments or to provide services that are inconsistent with safe and sound operations. To the contrary, the FDIC anticipates banks can meet the standards of this part with safe and sound loans, investments, and services on which the banks expect to make a profit. Banks are permitted and encouraged to develop and apply flexible underwriting standards for loans that benefit low- or moderate-income geographies or individuals, only if consistent with safe and sound operations." 12 C.F.R. § 345.21(d).

[94] "(2) *Benefit outside assessment area(s).* The FDIC considers the qualified investments, community development loans, and community development services that benefit areas outside the bank's assessment area(s), if the bank has adequately addressed the needs of its assessment area(s)."

3. Technical Assistance. The Bank will work with organizations in its assessment area to provide technical assistance to community-based nonprofit organizations and development agencies.

4. Program Sponsorship. The Bank will sponsor special programs or services in the Salt Lake community that provide services to low- and moderate-income residents related to housing, job creation and other CRA-qualified community development programs and services.

5. Assessment Area Needs Assessment: Housing. The Bank will invest in, and provide service to community organizations engaged in affordable housing rehabilitation and construction, including multifamily rental housing.

6. Assessment Area Needs Assessment: Community Development. The Bank will focus on developing relationships with community organizations and facilities that promote community development in low- and moderate-income areas for low- and moderate-income individuals.

7. Training Programs. The Bank will develop and administer a formal employee training program with regard to current consumer regulations, current civil rights laws and the Bank's policies and procedures.

8. Community Development CD. The Bank will market its community development certificate of deposit product to over 43,000 Section 501©(3) qualified nonprofit organizations on a regular basis. By offering above market interest rates or lower than market rate minimum account thresholds, these accounts will benefit these community service organizations and thus indirectly support their community activity.

9. Wal-Mart Involvement. The Bank will work to develop and leverage existing and future CRA-qualified activities of Wal-Mart's Salt Lake County and other Utah stores, the associates in these stores and other affiliated organizations to benefit the Bank's CRA Assessment Area and other Utah communities.

The Bank will also exhibit excellent responsiveness to credit and community economic development needs in its assessment area by doing the following:

1. Community Leadership – In addition to the established and ongoing leadership service of its CEO-designate with two local organizations, the senior management team and other officers of the Bank will assume leadership or advisory roles in community development, housing or social service agencies within the Bank's assessment area.

2. Ongoing Needs Assessment – The Bank's CRA Officer will conduct needs assessment interviews with local community development, housing and social service agencies.

3. Initiatives and Commitments – The Bank's CRA Officer and the Board of Directors will identify and evaluate the effectiveness of potential community-related investments, those that contribute to meeting community credit or development needs.

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?

Response: As suggested above, the Moratorium provides the opportunity to engage in a rigorous inquiry into important public policy arguments.

As this discussion suggests, opponents of ILCs have attacked these entities and their framework of regulation and supervision by citing Congressional policy to "separate banking and commerce" and for the need for "consolidated supervision." At the same time, those critics have not presented adequate facts or evidence supporting the need to restrict ILCs. Indeed, it also provides the FDIC with a timely window to address comprehensively "best practices" in the supervision of complex organizations and to appraise the quality, validity and effectiveness of the approaches of other regulators.

The Request will both provide a sound basis for determining the appropriateness and quality of ILC supervision and regulation AND will give the FDIC important and timely insight into the adequacy and appropriateness of the supervision and regulation of other large complex organizations which do have the scale and reach to pose systemic risk and risk to the Deposit Insurance Fund.

The Request also provides an opportunity to look more broadly at the financial structure and framework of regulation that was enacted in the GLB Act. Consideration of the issues posed by ILCs, including the role and authority of the respective financial regulators, the implication of restrictions on bank ownership both for consumers and the financial system, and the nature and structure of financial regulation is timely in light of the seven years that have passed since the enactment of that landmark legislation.

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?

Response: The FDIC authority to supervise ILC organizations is plenary and based on past experience needs no enhancement.

As suggested above, we do believe that there are limits on the FDIC's authority to advance a separation of banking and commerce policy by promulgating a regulation or otherwise generally restricting ownership of ILCs by commercial firms. In this context it is perhaps worth recalling the judicial review of the amendments to Regulation Y adopted in 1984, which sought to prevent the utilization of the so-called nonbank bank as a means for diversified and commercial firms to have a bank affiliate that was not a "bank" for purposes of the BHC Act.[95] In an 8-0 decision, the Supreme Court in the *Dimension* case struck down those Reg Y amendments.[96]

We believe that this case means that an agency cannot seek to use its administrative powers beyond its statutory boundaries to nullify clear statutory terms.[97] We further suggest that

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[95] The Fed also regarded industrial loan companies as a type of "nonbank bank." *See Dimension*, 474 U.S. 361, n. 3 (1986). ("The Board also noted that the powers of previously unregulated industrial banks 'have substantially expanded . . . making them for all intents and purposes banks' for the purposes of the Bank Holding Company Act. *49 Fed. Reg., at 834*").

[96] As summarized by the Court, the Fed justified the Reg Y changes as follows: "In 1984, the Board initiated rulemaking to respond to the increase in the number of nonbank banks. After hearing views of interested parties, the Board found that nonbank banks pose three dangers to the national banking system. *First*, by remaining outside the reach of banking regulations, nonbank banks have a significant competitive advantage over regulated banks despite the functional equivalence of the services offered. *Second*, the proliferation of nonbank banks threatens the structure established by Congress for limiting the association of banking and commercial enterprises. *See* 12 U. S. C. § 1843(c)(8) (bank holding company can purchase nonbanking affiliate only if entity "closely related to banking") 474 U.S. at 366-67. (The Fed's third point was that nonbank banks could be used for interstate banking despite BHC Act limitations on such banking.) The Court then addressed the Fed's effort to stifle nonbank banks by expanding the scope of the Reg Y definition of "bank." Despite the Fed's "broad regulatory authority," the Court struck down the amended rule as inconsistent with the plain terms of the statute in the case of one change and as "not a reasonable interpretation" of the statutory definition in the other. *Id*. at 368-70, 373.

The Court also addressed the Fed's assertion that its amendments could be sustained because they "fall within the 'plain purpose' of the Bank Holding Company Act. Nonbank banks must be subject to regulation, the Board insists, because 'a statute must be read with a view to the "policy of the legislation as a whole" and cannot be read to negate the plain purpose of the legislation.'" *Id*. at 373. In rejecting that argument the Court stated: "Application of 'broad purposes' of legislation at the expense of specific provisions ignores the complexity of the problems Congress is called upon to address and the dynamics of legislative action." *Id*. at 373-74. This aspect of the Court's analysis is specifically pertinent to the arguments made by ILC critics that the BHC Act provision concerning ILCs should not be read by its plain terms because Congress did not intend for the ILC growth that has occurred.

[97] We believe that "banking and commerce" is not an element of any of these statutory factors in 12 U.S.C. § 1816. Further, no one has provided any evidence whatsoever that commercial ownership of an ILC in and of itself is adverse to the safety-and-soundness of the ILC. Accordingly, we do not believe that the FDIC can make any findings under its own statute that would support a rule or policy generally barring ILC-commercial affiliations. If the

[Footnote continued on next page]

Dimension has the necessary corollary that an agency must administer the laws enacted by Congress in accordance with their terms, and while it may take reasonable time to make determinations on the applications before it,[98] it must make its determination based upon the law before it.

However, as suggested above, the FDIC does have the authority and capacity to create a framework of supervision and regulation which, while different from that under the BHC Act, is no less rigorous, comprehensive and effective. The FDIC has demonstrated its authority and effectiveness in the past as ILC supervision has evolved, and it has the capacity to continue to do so.

[Footnote continued from previous page]

FDIC sought to adopt a rule or policy to implement in effect a "separation of banking and commerce" involving ILCs, we believe that the logic and analysis of the Court in *Dimension* would be very instructive.

[98] We note that in Section 343(a) of the Riegle Community Development and Regulatory Improvement Act of 1994, Congress specifically addressed the need for timely agency action on applications.

APPENDIX 1: Legislative History of 12 U.S.C. § 1841©(2)(H).

In 1987, Congress extensively considered issues concerning the ability of commercial firms to control an FDIC-insured bank. The Competitive Equality Banking Act of 1987 ("CEBA") amended the federal Bank Holding Company ("BHC") Act to restrict the ability of nonbanking companies to own an FDIC-insured bank. However, an amendment proposed by Sen. Alan Cranston provided an express basis in the BHC Act for any type of company to control an industrial bank.

Prior to 1987, nonbanking companies including Sears, J.C. Penney, and American Express controlled FDIC-insured banks that did not accept demand deposits—so-called "nonbank banks." Concerned with the implications of these affiliations, Congress considered legislation that would bar such affiliations in the future. As stated in the Senate report on that legislation: "An unintended loophole in the Bank Holding Company Act has resulted in a situation in which any company can own a bank—a so-called nonbank bank—thus breaking down the banking/commerce separation that has served our nation so well." S. Rep. 100-19 at p. 2. To prevent such affiliations in the future, the bill as proposed would amend the BHC Act to provide that an FDIC-insured bank would be a "bank" under the BHC Act and that any company that controlled such a "bank" would have to conform to the limitations on bank holding companies set forth in the BHC Act. Id. at p. 11.

Although this "nonbank bank" proposed change was accepted, the Senate Banking Committee also adopted an express exception to this new definition of the term "bank" applicable to industrial loan companies and industrial banks chartered by states, such as California and Utah, that had authorizing statutes in 1987. During the Committee mark-up on March 10, 1987, that amendment was proposed by the ranking Democrat on that Committee, Sen. Alan Cranston, as "Cranston Amendment No. 8", and adopted. That amendment, as subsequently modified by Sen. Jake Garn and adopted by the Senate, was codified at 12 U.S.C. § 1841©(2)(H). It provides that any type of company may control a industrial bank chartered by states then providing an ILC charter without falling under the BHC Act, as long as that institution does not "accept demand deposits that the depositor may withdraw by check or similar means for payment to third parties" ("demand deposits"). *See* S. Rep. 100-19 at p. 30. *See also* Cong. Rec.—House H6889, 6890 (July 31, 1987). As enacted, section 2©(2)(H) of the BHC Act, provides that a BHC Act "bank" does not include:

> (H) An industrial loan company, industrial bank, or other similar institution which is-- (i) an institution organized under the laws of a State which, on March 5, 1987, had in effect or had under consideration in such State's legislature a statute which required or would require such institution to obtain insurance under the Federal Deposit Insurance Act-- (I) which does not accept demand deposits that the depositor may withdraw by check or similar means for payment to third parties; (II) which has total assets of less than $ 100,000,000; or (III) the control of which is not acquired by any company after the date of the enactment of the Competitive Equality Amendments of 1987 [enacted Aug. 10, 1987]; or (ii) an institution which does not, directly, indirectly, or through an affiliate, engage in any activity in which it was not lawfully engaged as of March 5, 1987, except that this

> subparagraph shall cease to apply to any institution which permits any overdraft (including any intraday overdraft), or which incurs any such overdraft in such institution's account at a Federal Reserve bank, on behalf of an affiliate if such overdraft is not the result of an inadvertent computer or accounting error that is beyond the control of both the institution and the affiliate.

12 U.S.C. § 1841 (c)(2)(H).

This industrial bank amendment to CEBA is part of federal law and as such is an element of federal policy regarding the appropriate relationship between "banking" and "commerce." That federal policy plainly permits a commercial company to control a Utah industrial bank that does not accept demand deposits.

In 1995-1999, Congress again considered federal policy concerning affiliations between insured depository institutions and nonbanking companies. Federal Reserve Chairman Greenspan and others did reiterate their position concerning a federal policy to separate "banking" and "nonfinancial" activities. In furtherance of such a policy the GLB Act in Title I did amend the BHC Act to permit "financial" affiliations for banks and in Title IV amended the Savings and Loan Holding Company Act ("S&LHC Act") to restrict new affiliations between "unitary" S&LHCs engaged in nonfinancial activities and FDIC-insured savings associations. *See* 12 U.S.C. § 1467a(c)(9).

Nevertheless, at the same time the GLB Act made these changes, it both retained the original CEBA provision permitting any type of company to control a California ILC that does not take demand deposits and *added* liberalizing language. *See* Section 107(c) of the GLB Act, amending 12 U.S.C. § 1841(c)(2)(H). And it did so two years after Utah has amended its law to permit the chartering of new ILCs with broader powers[99] and after a significant number of major diversified financial and nonfinancial companies had acquired Utah ILCs. This action necessarily leads to the conclusion that Congress did not intend to sweep industrial banks into any general "separation of banking and commerce" and specifically reaffirmed the existing opportunity for any type of company to control an ILC.

As amended by the GLB Act, the BHC Act now provides (language added by the GLB Act is italicized):

> (H) An industrial loan company, industrial bank, or other similar institution which is-- (i) an institution organized under the laws of a State which, on March 5, 1987,

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[99] As the Fed noted in its July 12, 2006, testimony: "For example, in 1997, Utah lifted its moratorium on the chartering of new ILCs, allowed ILCs to call themselves banks, and authorized ILCs to exercise virtually all of the powers of state-chartered commercial banks. In addition, Utah and certain other grandfathered states recently began to charter new ILCs and to promote them as a method for companies to acquire a federally insured bank while avoiding the requirements of the BHC Act."

had in effect or had under consideration in such State's legislature a statute which required or would require such institution to obtain insurance under the Federal Deposit Insurance Act-- (I) which does not accept demand deposits that the depositor may withdraw by check or similar means for payment to third parties; (II) which has total assets of less than $ 100,000,000; or (III) the control of which is not acquired by any company after the date of the enactment of the Competitive Equality Amendments of 1987 [enacted Aug. 10, 1987]; or (ii) an institution which does not, directly, indirectly, or through an affiliate, engage in any activity in which it was not lawfully engaged as of March 5, 1987, except that this subparagraph shall cease to apply to any institution which permits any overdraft (including any intraday overdraft), or which incurs any such overdraft in such institution's account at a Federal Reserve bank, on behalf of an affiliate if such overdraft is not the result of an inadvertent computer or accounting error that is beyond the control of both the institution and the affiliate, *or that is otherwise permissible for a bank controlled by a company described in section 4(f)(1) [12 U.S.C. § 1843(f)(1)]*.

APPENDIX 2: The FDIC Supervisory Program for ILC Organizations is Comprehensive and is Equivalent in Comprehensiveness and Effectiveness to the Home Country Consolidated Supervision Standards Implemented by the EU for U.S. organizations and by the Fed for Non-U.S. Banking Organizations

This Appendix compares the principal elements of the FDIC's existing, comprehensive program for examining and supervising insured banks, including ILCs and their affiliates, to the international standards used for determining when a banking supervisor may be deemed to provide a "consolidated home country supervision" for banking and financial organizations based in that home country.

The first section provides excerpts from the FDIC Risk Management Manual of Examination Policies ("Exam Manual") concerning the supervision of affiliates and its Large Insured Depository Institution ("LIDI") Program. The FDIC's success as a supervisor of ILC organizations is based upon the scope and effectiveness of this program. The next sections summarize the EU's supervisory standards under its Conglomerates Directive and its application of those standards to U.S. organizations under the jurisdiction of the OTS, SEC, and New York Banking Department. The final section excerpts the Fed rule setting forth its standards for determining whether the home country supervisor of a non-U.S. banking organization provides "consolidated home country supervision." These Fed standards closely parallel the EU and international standards applied to U.S. organizations.[100]

This review demonstrates that the FDIC's safety-and-soundness examination program is a comprehensive and effective supervision program that addresses ILC organizations of all sizes and degrees of complexity. The comparison with the EU and Fed standards for "consolidated supervision" further demonstrates that the FDIC program incorporates the goals, standards, and methods of consolidated supervision into its supervision of ILCs, their parents, and affiliates. Thus, whatever label is applied, the FDIC's program compares favorably in terms of comprehensiveness and effectiveness.

FDIC's Existing Supervision of ILC Organizations

This section reviews key elements of the FDIC's existing, comprehensive program for examining and supervising insured banks, including ILCs and their affiliates. It presents excerpts from the Exam Manual and LIDI Program guidance.

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[100] The U.S. and EU standards and programs also reflect the work of the Basel Committee on Banking Supervision of the Bank for International Settlements, including the Concordat on "Minimum standards for the supervision of international banking groups and their cross-border establishments" (July 1992) http://www.bis.org/publ/bcbsc314.pdf; The Supervision of Cross-Border Banking Report (October 1996) http://www.bis.org/publ/bcbs27.pdf; and High-level principles for the cross-border implementation of the New Accord (August 2003), http://www.bis.org/publ/bcbs100.pdf.

FDIC Exam Manual. Section 4.3 of the FDIC Exam Manual sets forth in detail the overall FDIC examination program with respect to affiliates of insured banks. A significant portion of this section addresses organizations that control an ILC but are not a BHC. It includes a section particularly addressing “Unique Characteristics of Commercial Parent Companies,” which provides:

> Certain bank charters, such as ILCs, may have commercial parent companies in place of a traditional bank holding company or financial institution holding company. As with bank holding companies, these commercial parents can be a source of strength for their subsidiary bank by providing access to the capital and debt markets, and affording the opportunity to use a variety of technical services not always available to small or mid-size banks.
>
> However, commercial parents also present different management challenges to the insured institution and different analytical challenges to examiners. Commercial parents may not be able to offer additional management expertise directly relevant to financial institutions. In serving the specific financial needs of a commercial company, a niche bank may be insufficiently diversified against credit or liquidity risks. Further a financial catastrophe at a parent or affiliate, unrelated to the business of the insured institution, could result in an unanticipated but immediate disruption to the earnings or operations of the insured entity.
>
> Moreover, assessment of “extra-insured” risk factors cannot be made with the comparatively straight-forward ratio analysis used for evaluating bank holding companies. Commercial firms present more varied revenue streams and business risks. Further, while a clearly identified weakness in the insured institution will generally determine the need to conduct an assessment of the potential source of strength provided by the commercial parent, any determination of a “potential source of weakness” presented by a parent or affiliate to an otherwise healthy insured entity will be far more complex. Examiners should only undertake such an assessment following consultation and direction from the Regional Office.
>
> For nonbank holding companies or commercial parent entities, some possible sources for financial analysis include: parent entity quarterly or annual reports, Securities and Exchange Commission filings such as 10-Ks, 10-Qs, etc., bank records on affiliates, external industry analysis sources (i.e. Moody’s Standard and Poor’s, etc.), internal and/or external audits, corporate press releases, newspaper articles, etc.

Section 4.3 specifically addresses a range of issues and analytical methods for assessing the ability of the parent to serve as a source of financial strength to its bank affiliate:

> The holding company structure can provide its subsidiary bank strong financial support because of greater ability to attract and shift funds from excess capital areas to capital deficient areas. The financial support can take the form of equity capital injections and/or the funding of loans and investments. However, when the financial condition of the holding company or its nonbanking subsidiaries is

tenuous, pressures can be exerted on the subsidiary banks. In order to service its debt or provide support to another nonbank subsidiary, the holding company may place inordinate financial pressure on its subsidiary banks by any of the following methods: payment of excessive dividends; pressure subsidiary banks to invest in high risk assets to increase asset yields; purchase and/or trade its high quality assets for the other affiliate's lower quality assets; purchase of unnecessary services from affiliates; or payment of excessive management or other fees. . . .

Even when the holding company is financially sound, supervisory concerns may arise as the parent issues long term debt to fund equity capital in the subsidiaries. Although this capital raising activity, known as "double leveraging," does increase equity capital in the subsidiary, too much debt at the holding company level can generate pressure on the subsidiary to upstream additional dividends. . . .

The double leverage ratio is the equity of the subsidiary, or in the case of multiple subsidiaries the combined equity of all the subsidiaries; divided by the equity of the holding company. A holding company with a ratio of 100% or less, is not using double leverage. The amount of double leverage a holding company can comfortably carry can depend on various factors; but analysis should center on the amount of earnings or cash flow which the subsidiaries, or the lead bank if the lead bank generates most of the combined company's earnings, can upstream to the parent. Even holding companies with comparatively modest double leverage ratios can negatively affect the bank if the non-bank subsidiaries produce negative cash flow. Other leverage ratios which attempt to isolate or incorporate different segments of the holding company's capital structure (preferred stock or minority interests for example) can be useful for assessing more complex organizations.

Fixed charge coverage is a ratio that measures the ability of the parent company to cover its interest expense. . . .

Cash flow match is a more severe test of parent cash availability to meet not only interest expenses, but also operating expenses, taxes, shareholder dividends, and debt maturities. . . .

These cash flow measures are the best indicators of the financial support a parent company can provide to a subsidiary bank. Asset size, capitalization, revenue or profitability; even relative to the size of the insured institution, are imperfect measures for gauging potential support.[101]

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[101] http://www.fdic.gov/regulations/safety/manual/section4-3.html#parent. Both Chairman Powell and Commissioner Leary have commented in their coordination to implement the LIDI program for the major ILC organizations. *See* CSBS Remarks, *supra*, and Leary testimony of July 12, 2006.

LIDI Program. In addition to the general approaches discussed in the Exam Manual, the FDIC has addressed particular issues arising from large organizations that include an ILC in its Large Insured Depository Institution (LIDI) Program. The LIDI program builds on and parallels the Fed's Large Complex Banking Organization (LCBO) program to look at the major banking organizations under their supervision on a consolidated basis.[102] On March 12, 2004, the FDIC Division of Supervision and Consumer Protection (DSCP) specifically expanded the LIDI Program to include organizations not subject to the BHC Act, including ILC organizations. (Transmittal 2004-009).[103] In that memorandum the Director of DSCP stated:

> The FDIC regulates these banking institutions [including ILCs] in the same manner as other state nonmember banks with respect to examination, enforcement and other supervisory activities. However, there are differences regarding the oversight of the organizations that own these institutions since they are not depository institution holding companies and therefore not subject to Federal Reserve supervision.
>
> Case Managers and other Regional Office supervisory staff are encouraged to review their portfolios of insured depository institutions with non-bank holding company ownership structures and determine if they should be added to the LIDI program. Staff should include entities where the organizational structure and strategic focus of the parent company present significant risks to the depository institution, even if the risks are currently well-controlled.
>
> As with any institution, our supervisory objective is to identify changes to the risk profile as early as possible. Review staff should pay particular attention to the depository institution's relationship with its parents and other related organizations. In general, quarterly reviews of these entities should focus on such areas as controls and safeguards over conflicts of interest, controls over intercompany transactions, and the possible existence of abusive activities by related parties.
>
> If added to the LIDI program, staff should prepare a quarterly *Executive Summary* and assign an LIDI offsite rating. (italics in original)

As discussed in the CMPM, the LIDI Program "provides timely, comprehensive, and forward-looking analyses of risk profiles of companies with total assets of $10 billion or more, on a consolidated entity basis. Companies with consolidated total assets of at least $3 billion but less than $10 billion can be added to the LIDI Program at the discretion of the Regional Director.

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[102] The LIDI program is discussed in detail in chapter 11 of the FDIC Case Manager Procedures Manual (4-04) ("CMPM").

[103] At present there are five ILC organizations supervised under this program and one in the large bank dedicated examiner program. *See* 2006 FDIC/OIG Report at Table 7, p. 27.

Although LIDI companies are primarily holding companies, the Program also includes unit banks and thrifts that meet their asset size thresholds. Timely and complete analysis of the risk profiles of these companies provides a proactive approach aimed at identifying and monitoring the largest risks to the insurance fund. In order to quantify the analysis and facilitate overall trend analysis, an offsite rating and risk profile indicator are assigned to each company on a quarterly basis."[104] As set forth in the CMPM, the LIDI Program analyzes companies in four main areas:

- The organizational structure and strategic focus of the company
- The overall risk profile and financial condition of the company
- An identification and review of significant issues, current events, and challenges facing the company
- The review and development of a sufficient supervisory program to address the risk issues facing the company[105]

The CMPM discussion of the LIDI Program is lengthy and detailed and makes it plain that the quarterly analysis should consider all significant aspects of the organization's financial condition, management and controls, business developments and sources of risk. The LIDI Program demonstrates that the FDIC not only has the authority to address comprehensively the substance and dynamics of the relationships between ILCs and their affiliates, but more importantly has a program in place that does just that and that is comparable to the parallel LCBO program implemented by the Fed.

<u>Consolidated Supervision as Implemented by the European Union</u>

We recognize that consolidated supervision is an important concept in banking supervision around the world and that in the United States, the EU, and other countries around the world, banking organizations must be found to be subject to consolidated home country supervision before being allowed to do banking business in other countries.[106] Over the last decade financial regulatory authorities in Europe and the United States particularly have given substantial attention to the concept and implementation of consolidated supervision of financial conglomerates. During the last five years, as the European Union has implemented its Conglomerates Directive, which is based on the concept of consolidated supervision of large complex operations, the U.S. financial agencies, with the cooperation of the Treasury Department, have dealt with the subject of supervision and regulation of enterprises which have banking components but which are not traditional banking organizations supervised by the Federal Reserve. The SEC has been accepted as a consolidated supervisor of Merrill Lynch and

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[104] CMPM at 11-1.

[105] *Id.* at 11—1-2. (italics in original).

[106] *See* the Basel Committee documents set forth in footnote 99, *supra.*

Morgan Stanley and the OTS as consolidated supervisor of the financial and banking activities of General Electric.

In releasing its Conglomerates Directive in 2001, the EU indicated that it had three principal objectives:

- To ensure that the financial conglomerate has adequate capital. In particular the proposed rules would prevent the same capital being counted twice over and so used simultaneously as a buffer against risk in different entities in the same financial conglomerate ('multiple gearing'). The proposal would also prevent "downstreaming" by parent companies whereby they issue debt and then use the proceeds as equity for their regulated subsidiaries ("excessive leveraging");

- To introduce methods for calculating a conglomerate's overall solvency position and

- To deal with the issues of intra-group transactions, exposure to risk and the suitability and professionalism of management at financial conglomerate level.[107]

In 2004, the European Financial Conglomerates Committee and the EU Banking Advisory Committee jointly prepared a "general guidance" addressing "the extent to which the supervisory regime in the United States of America is likely to meet the objectives of consolidated supervision."[108] The guidance took account of the roles of the four federal banking agencies, the state banking agencies, the SEC, state securities agencies and the securities self-regulatory organizations, and the roles of the National Association of Insurance Commissioners (NAIC) and state insurance commissioners. Based on this review it concluded: "The range of authorities involved means that reaching a single conclusion on whether the US supervisory regime as a whole achieves the objectives of consolidated and supplementary supervision is difficult. Nonetheless, we are of the view that, on balance, there is broad equivalence in the US supervisory approaches, notwithstanding the caveats noted below."[109] The guidance then made specific comments on the use of supervisory agreements by the New York State Banking Department, the approach to capital adequacy by the OTS,[110] and the fact that the SEC would be

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[107] European Commission, "Financial services: Commission proposes Directive on prudential supervision of financial conglomerates**,"** Press release IP/01/609 (Brussels, 26 April 2001).

[108] EFCC/BAC general guidance – USA supervision, Final 06.07.2004. at http://ec.europa.eu/internal_market/financial-conglomerates/docs/guidance-usa-final-060704_en.pdf.

[109] *Id.* at 3.

[110] "The OTS does not have a uniform approach to capital requirements at the holding company level. We understand the thinking behind this approach, given the diversity of organizations

[Footnote continued on next page]

undertaking a form of consolidated supervision for the first time.[111] Noting that several of the supervisory regimes for financial groups had been recently adopted and implemented, the guidance indicates that the practices followed by the agencies should be reviewed in 2006. No further assessment has to date been released.

The FDIC examination and supervision program described above plainly satisfies the EU criteria.

Fed Implementation of Consolidated Supervision for Non-US Banking Organizations

This EU document does not discuss the Fed's approach to holding company supervision, presumably because of the Fed's long-established role as a consolidated supervisor of holding companies. We note that the Fed has established parallel standards for determining when a non-U.S. bank is subject to consolidated home country supervision and that the Fed's rule on this subject also focuses on the ability of the foreign country supervisor to achieve the results of consolidated supervision and not on the specific means adopted.

The Fed rule[112] provides:

> (ii) *Basis for determining comprehensive consolidated supervision.* In determining whether a foreign bank and any parent foreign bank is subject to comprehensive consolidated supervision, the Board shall determine whether the foreign bank is supervised or regulated in such a manner that its home country supervisor receives sufficient information on the worldwide operations of the foreign bank (including the relationships of the bank to any affiliate) to assess the foreign bank's overall financial condition and compliance with law and

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which have a thrift-holding company. However, this does mean that EU supervisors must ensure that they fully understand the way in which capital requirements are applied to a particular group, and be satisfied that this delivers an outcome that is consistent with the objectives of consolidated or supplementary supervision." *Id*. at 4.

[111] "There are some important aspects of the SEC's CSE1 regime that EU supervisors must take into account. In particular, EU supervisors must consider the extent of reliance by groups on the inclusion of unsubordinated long-term debt in capital for a transitional period, and consider whether this poses a problem. The CSE regime will apply Basel-like standards for capital calculation at the holding company level. Given the way in which these groups have evolved, EU supervisors must consider whether there is enough mobile capital in the group to cover the risks arising from the activities of unregulated entities. Such consideration must also take into account the application to any regulated US broker-dealers in the group of capital standards that are more onerous than the Basel standards." *Id*. at 5.

[112] *See* 12 C.F.R. § 211.24(c)(ii).

regulation. In making such a determination, the Board shall assess, among other factors, the extent to which the home country supervisor:

(A) Ensures that the foreign bank has adequate procedures for monitoring and controlling its activities worldwide;

(B) Obtains information on the condition of the foreign bank and its subsidiaries and offices outside the home country through regular reports of examination, audit reports, or otherwise;

(C) Obtains information on the dealings and relationship between the foreign bank and its affiliates, both foreign and domestic;

(D) Receives from the foreign bank financial reports that are consolidated on a worldwide basis, or comparable information that permits analysis of the foreign bank's financial condition on a worldwide, consolidated basis;

(E) Evaluates prudential standards, such as capital adequacy and risk asset exposure, on a worldwide basis.

Like the EU, the Fed recognizes that "consolidated supervision" is not a single supervisory template.