HOUSE COMMITTEE ON FINANICAL SERVICES

HEARING ON:

THE INDUSTRIAL BANK HOLDING COMPANY ACT OF 2007

WEDNESDAY, APRIL 25, 2007

WRITTEN TESTIMONY OF JOHN L. DOUGLAS

ON BEHALF OF

THE AMERICAN FINANCIAL SERVICES ASSOCIATION

HOUSE COMMITTEE ON FINANICAL SERVICES

HB 698 – The Industrial Bank Holding Company Act of 2007
Wednesday April 25, 2007

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I appreciate the opportunity of providing testimony on this important bill. By way of background, I am a partner in the law firm of Alston & Bird and am pleased to represent the American Financial Services Association ("AFSA") before this panel. AFSA is the national trade association for the consumer credit and finance industry. It represents the nations' market rate lenders providing access to credit for millions of Americans. AFSA's 300 member companies include consumer and commercial finance companies, "captive" auto finance companies, credit card issuers, mortgage lenders, industrial banks, and other financial service firms that lend to consumers and small businesses.

AFSA strongly believes that the industrial bank option represents a safe, sound and appropriate means to deliver financial services to the public. Congress appropriately established a strict legal framework within which commercial companies, such as those that are members of AFSA, can provide deposit, loan and other banking products. This framework is highlighted by stringent and appropriate supervision, by strong enforcement powers and by a structure of laws and regulations that mitigate the consequences of the hypothetical – and unproven – evils raised by the opponents of the industrial bank charter.

I also come with personal background and experience on this issue, having served as General Counsel of the Federal Deposit Insurance Corporation from 1987 through 1989, a period of tremendous stress in our financial system, where we witnessed the massive bank and thrift failures of the late 1980's, the insolvency of the Federal Savings and Loan Insurance Corporation, the creation of the Resolution Trust Corporation and the appropriation of billions of taxpayer dollars by Congress to resolve the crisis. In recent years, I have also provided advice to banking regulators in Russia, Egypt, and Indonesia, and I know, first-hand, the range of problems that flow from lax supervision. I have a healthy respect for the need for a safe and sound financial system. Both before and since my service as the FDIC's General Counsel, my legal practice has been devoted to the representation of a number of banking and non-banking entities engaged in the financial services business.

The Industrial Bank Holding Company Act of 2007 attempts to wrap itself in the cloak of protecting the public from some great danger that will result if commercial companies are allowed to own depository institutions. This bill, however, is fundamentally flawed.

First, at its heart, the legislation is anti-competitive. It allows certain companies to innovate with the delivery of financial services and products to the public, but denies that right to others. It permits some companies to assess the needs of their customers and address them proactively and directly, but precludes others from doing so. As a nation we have benefited greatly from the innovation that comes with competition; this bill would represent a step back. Parenthetically, it also excludes from the banking system important sources of capital and managerial talent. It wasn't that long ago that both were sorely lacking in our banking system, and the capital and strength provided by commercial and industrial owners was crucial.

Second, it presumes that the FDIC somehow lacks the power and authority to protect our banking system since it lacks the "comprehensive supervision" authority granted to the Federal Reserve over bank holding companies. Implicit in this presumption is that there is a looming safety and soundness issue associated with the regulatory framework governing industrial banks and their owners. There is no factual basis for this presumption.

Third, it assumes that the mixing of banking and commerce is a new development in our country that poses an extreme threat to our banking system. It ignores the history of banking in the United States, where such affiliations have always existed, and certainly ignores the modern history of banking regulation where Congress has explicitly blessed affiliations between banking and commercial firms. [1]

Finally, it attempts to distinguish between "good" owners of industrial banks (the financial firms) and "bad" owners of industrial banks (the commercial firms), without any evidence whatsoever that one poses a greater threat than the other.

I wish to devote my remarks to the second point – that the commercial ownership of industrial banks poses a threat to our system due to the lack of comprehensive supervision. I make four major points in response:

- First, industrial banks are subject to the same comprehensive framework of supervision and examination as "normal" commercial banks. They have no special powers or authorities; they are exempt from no statute or regulation. They must abide by the requirements of: Sections 23A and B, limiting and controlling transactions with affiliates;[2] Regulation O, governing loans to officers, directors or their related interests;[3] capital requirements;[4] the Prompt Corrective Action

[1] As to the "historic" separation of banking and commerce, I will merely note that it wasn't until 1956 that activity restrictions were place on multi-bank holding companies and that those restrictions weren't extended to single bank holding companies until 1970. Further, it wasn't until 1999 that activity restrictions were imposed on unitary savings and loan holding companies. As for whether the industrial bank represents an "unintended loophole," as many have suggested, Congress has extensively considered industrial banks on numerous occasions, most extensively as part of the Competitive Equality Banking Act in 1987, and again as part of the Gramm-Leach-Bliley Act in 1999.

[2] 12 U.S.C. 371c, and 371c-1.

[3] 12 C.F.R. 215. See 12 U.S.C. 1817(k)(3).

[4] 12 C.F.R. 325.

safeguards instituted by Congress in the early 1990's that assure maintenance of adequate capital and impose an ever-increasing level of supervisory control if institutions fail to do so;[5] and all of the other laws, rules and regulations that promote safe and sound banking in this country. It is important to note that the Industrial Bank Holding Company Act does not change this framework in any respect.

· Second, the FDIC has been given full and ample authority to supervise and regulate these institutions, and can exercise the full range of enforcement authorities granted by Congress. I was a participant in the political process that led to Congress' rewrite of those provisions in 1989, as part of FIRREA,[6] and I personally can attest to the scope of the cease and desist, removal and prohibition, civil money penalty and withdrawal of deposit insurance powers. It was our clear intention to give the FDIC and the other bank regulators all of the enforcement powers they needed to protect the banking system. Importantly, all of these enforcement powers apply with full force to an industrial bank, as well as to any officer, director, controlling shareholder or "any other person that participates in the conduct of the affairs of the institution."[7] There is no question that to the extent that either the corporate owner of an industrial bank or any affiliate of that owner engages in any violation of law, rule or regulation applicable to the industrial bank, or has engaged, is engaging or is about to engage in an unsafe or unsound practice relating to the industrial bank, the FDIC can bring the full range of enforcement authorities to bear. These remedies can include not only requiring that impermissible or inappropriate activities cease immediately,[8] but also requiring that the condition be remedied and restitution made.[9] Civil money penalties up to one million dollars per day can be imposed,[10] and individuals can be removed from their positions and precluded from having any involvement not only with the industrial bank but with *any* insured depository institution.[11] The FDIC can also restrict the activities of the industrial bank or any affiliate participating in its affairs, can withdraw the deposit insurance of the industrial bank[12] and take any other action it "deems appropriate" in the event of a violation of law, rule or regulation, including forcing the divestiture of the industrial bank by its owner.[13] The Industrial Bank Holding Company Act gives the FDIC no

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[5] 12 U.S.C. 1831o. See also 12 C.F.R. 325, Part B.
[6] The Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. 101-73, 103 Stat. 183 (Aug. 9, 1989), extensively revising 12 U.S.C. 1818.
[7] See 12 U.S.C. 1813(u) (definition of "institution-affiliated party") and 12 U.S.C. 1818.
[8] 12 U.S.C. 1818(b), (c).
[9] 12 U.S.C. 1818(b)(6).
[10] 12 U.S.C. 1818(i).
[11] 12 U.S.C. 1818(e).
[12] 12 U.S.C. 1818(a).
[13] As noted above, the FDIC has been given the explicit power to take any action the FDIC "deems appropriate" in the event of a violation of law, rule or regulation or engaging in an unsafe or unsound practice. See 12 U.S.C. 1818(b)(6)(F). Similarly, the FDIC has been given the power to "place limitations on the activities or functions of the insured depository institution or any institution-affiliated party." 12 U.S.C. 1818(b)(7). It also has the power to prohibit any "institution-affiliated party" from participating in the affairs of any financial institution under certain circumstances. Finally, the FDIC has been granted "all

power that it does not already possess over companies owning industrial banks and their affiliates.

· Third, I can attest from experience that the FDIC regularly and vigorously exercises these powers. The FDIC routinely requires an independent, fully functioning board of directors designed to assure that the industrial bank stands on its own and is not merely an arm of its corporate owner. The industrial bank must have adequate capital, operate in a safe and sound fashion, avoid unsafe and unsound practices, have comprehensive policies, controls and procedures, and an effective internal audit program. The FDIC rigorously examines the institution and closely scrutinizes transactions and relationships between the industrial bank and its affiliates. It conditions approvals to assure compliance with carefully crafted commitments designed to assure the safe and sound operations of the industrial bank. It forcefully uses its enforcement powers, and is not shy about inquiring about any action, transaction or relationship that might potentially affect the insured institution. Again, the Industrial Bank Holding Company Act grants the FDIC no power that it does not already possess.

· Finally, the experience of the FDIC with respect to industrial banks, similar to the experience of the OTS with respect to diversified owners of savings associations, belies any fundamental concerns over threats to the banking system or our economy that might arise from commercial ownership. There have only been two failures of FDIC-insured industrial banks owned by holding companies.[14] These holding companies were not commercial enterprises, they were solely engaged in financial activities. These two failures cost the FDIC roughly $100 million. Both failed not as a result of any self dealing, conflicts of interest or impropriety by their corporate owners; rather, they failed the "old fashioned way" – poor risk diversification, imprudent lending and poor controls. These two failures stand in sharp contrast to the hundreds of bank failures operating in holding company structures, many of which cost the FDIC billions of dollars. The list is long and sobering – Continental Illinois, First Republic, First City, MCorp, Bank of New England, and so on – many of which were subject to the much-vaunted "consolidated supervision" by the Federal Reserve as the

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powers specifically granted by the provisions of this chapter, and such incidental powers as shall be necessary to carry out the powers so granted." 12 U.S.C. 1819(a) (Seventh). In my view, the combination of these provisions would give the FDIC ample authority to force the "disaffiliation" between an industrial bank and its parent were the relationship between the two create an unsafe or unsound condition.

[14] The two institutions were Pacific Thrift and Loan (see http://www.fdic.gov/news/news/press/1999/pr9971.html) and Southern Pacific Bank (see http://www.fdic.gov/news/news/press/2003/pr1103.html). There were a series of small industrial bank failures between 1986 and 1996. All of these institutions had less than $60 million in assets and were essentially operated as finance companies. None had "commercial" parents or were part of holding company structures. Most were located in California and could not withstand the banking crisis of the late 1980's and early 1990's. They failed, according to the FDIC, as a result of "ineffective risk management and poor credit quality." See FDIC "Supervisory Insights, The FDIC's Regulation of Industrial Loan Companies: A Historical Perspective," http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/industrial_loans.html.

holding company regulator that is offered as a cure for something that hasn't proven to be a problem.[15]

I contrast the foregoing examples with the FDIC's experience with Conseco's banks in late 2002. Conseco owned a South Dakota credit card bank as well as a Utah-chartered industrial bank. Notwithstanding the highly publicized travails (and bankruptcy) of the parent, the well-capitalized and well-supervised banks did not fail or even particularly suffer as a result of the parent's problems.[16] The bank-centric approach to regulation and supervision served us all well. Indeed, while I recognize and appreciate the GAO's perspective that corporate owners of industrial banks are not subject to the same degree of consolidated supervision that bank holding companies must endure,[17] the more fundamental question should be whether that degree of consolidated supervision is necessary or even appropriate for owners of banks. Simply put, not everything that can be regulated should be regulated, and a bank-centered model of regulation I believe is better suited to assure innovation and vigorous competition in the banking industry.

Indeed, having strong owners of depository institutions with diversified sources of income may be more beneficial to our system than artificially limiting ownership to those that are engaged solely in activities so closely related to the business of banking as to be a proper incident thereto[18] or solely in financial activities as deemed permissible by the Federal Reserve.[19]

It may be useful to review a statement made by Lawrence White, now a professor at NYU and a former member of the Federal Home Loan Bank Board during the thrift crisis period of the late 1980's. In discussing the crisis, he noted the issues associated with diversified ownership of thrifts. Importantly, he observed the following: "The experience of thrift holding companies is instructive. The presence of companies involved in markets as diverse as autos, steel, wood products, retailing, public utilities, insurance and securities as holding company owners of thrifts has not created problems; the same would surely be true if these, or similar companies, had owned banks."[20]

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[15] The point is not that the FDIC is a better regulator than the Federal Reserve; rather, it is that there is no evidence that "consolidated supervision" (i.e., the holding company oversight provided by the Federal Reserve) is a panacea for bank failures.

[16] The Conseco example is extensively discussed by Christine Blair in The FDIC Banking Review, The Future of Banking in America, The Mixing of Banking and Commerce, Current Policy Issues, January 2005. See http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/industrial_loans.html. The FDIC's experience with Tyco's industrial bank was similar. Tyco's industrial bank survived the highly publicized problems of Tyco, thanks in great part to the supervision and oversight provided by the FDIC and the state regulator.

[17] Report 05-625, United States Government Accountability Office, Report to the Honorable James A. Leach, Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority, September 2005, found at http://www.gao.gov/new.items/d05621.pdf.

[18] 12 U.S.C. 1843(c)(8), the provision that primarily defines the permissible direct and direct activities of bank holding companies.

[19] 12 U.S.C. 1843(k), the provision adopted as part of Gramm-Leach-Bliley that primarily defines the direct and indirect activities of financial holding companies.

[20] L. White, *The S&L Debacle, Public Policy Lessons for Bank and Thrift Regulation* (New York, Oxford University Press, 1991) 242.

The supposed "ills" that would result from the continued use of industrial banks to deliver financial services are mere shibboleths. Critics assert that an industrial bank affiliated with a commercial firm would somehow favor its affiliates, discriminate against competitors, or create other unfair advantages unavailable to ordinary banks or bank holding companies. To the contrary:

- Existing laws preclude use of the industrial bank to provide any favorable accommodation to the commercial affiliate. Using an industrial bank to advantage a commercial affiliate is no more possible than for a national bank to advantage a financial affiliate. Self dealing and abusive behavior are effectively precluded by existing law and regulation.

- If potential discrimination were an issue, banks should not be affiliated with any type of business or entity. Indeed, if this is our worry, Bank of America should not be affiliated with Banc of America Securities lest the Bank unfairly favor customers of Banc of America Securities to the exclusion of customers of Merrill Lynch. Or to use a much more mundane example, might not First National Bank of Small Town America unfairly favor customers of its automobile leasing subsidiary to the exclusion of those that elect to lease from the automobile dealer?

- If we were really concerned about potential for abuses and adverse effects, we might more closely evaluate the propriety of the insurance agent, small business owner, real estate developer or car dealer owning a controlling interest in banks located in small communities where alternative sources of credit are much more limited. Congress has never acted to preclude affiliations between individuals and banking organizations based upon the business activities of the individual owners, nor should it, as the existing framework of laws and regulations is more than adequate to prevent any abuses.[21]

- Finally, if we were really concerned about the potential dangers of mixing banking and commerce, we should roll back the merchant banking powers recently granted banking organizations,[22] eliminate the FDIC's power to approve commercial activities for banks[23] and perhaps even strip commercial lending powers from banks, as there are few relationships giving a bank more power over,

[21] It is perhaps telling that the Federal Reserve, which would be in a position to report information on the extent to which business owners hold controlling interests in banking organizations or serve on the board of directors thereof has never, to my knowledge, reported on the nature or extent of such relationships or advised of the potential abuses that might result therefrom.

[22] 12 U.S.C. 1843(k)(4)(H).

[23] 12 U.S.C. 1831a, as implemented by 12 C.F.R. 362. Pursuant to this authority, the FDIC has allowed banks to engage in commercial and residential real estate development, construct mausoleums and sell crypts and niches, acquire a company engaged in the psychological study of leadership characteristics and purchase and hold a variety of equity securities. See generally http://www.fdic.gov/regulations/laws/bankdecisions/InvestActivity/index.html.

and a greater interest in, a commercial enterprise than to be the primary source of its funding.

Further to this last point. The unfairness of this bill is evidenced by one example. It is permissible under current law for any one of a number of banking organizations to use their powers granted under Gramm-Leach-Bliley to acquire *any* commercial entity. This bill would preclude any commercial entity from establishing a bank to facilitate meeting the needs of its customers.

One of the great strengths of our financial system is the sheer number of sources from which financial products and services can be obtained. We still have almost 7,500 commercial banks, 1,200 savings institutions and 8,600 credit unions. We have thousands of commercial companies that offer credit to consumers and businesses, and a variety of savings and investment products available outside the banking system. The industrial bank model represents only one of many options available for delivering financial services and products. Through that vehicle alone, billions of dollars of commercial and consumer credit have been made available to small businesses and individuals across the country. In my experience, companies elect to enter the banking business because they believe that they can meet the needs of their customers. They believe that they can do so profitably. The owners of industrial banks are no exception. If they are going to do so, of necessity it will be done in a safe, sound and prudent manner. Congress has given the FDIC the role and responsibility for assuring that this is so, and by any measure, it has done an exceptional job.

As I noted at the outset, I have been involved in providing advisory assistance to the banking regulators in Russia, Egypt and Indonesia, among others. Among the many weaknesses in those systems is the lack of vigorous competition in delivering financial services to the businesses and individuals in their respective countries. The breadth of our markets and the strength of competition within those markets have served us well. It would be unwise to roll back the clock by taking steps to limit competition for the sake of upholding outdated principles, however noble they might sound, that are now simply irrelevant to the issue at hand.

Thank you.