HOUSE COMMITTEE ON FINANICAL SERVICES

Subcommittee on Financial Institutions and Consumer Credit

ILCs -- A Review of Charter, Ownership, and Supervision Issues

Wednesday, July 12, 2006

WRITTEN TESTIMONY OF JOHN L. DOUGLAS ON BEHALF OF THE AMERICAN FINANCIAL SERVICES ASSOCIATION

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Good morning. My name is John Douglas, and I am a partner in the law firm of Alston & Bird. I 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 loan 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 provides the FDIC with all the tools it may need to address any 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 and inadequate enforcement. 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.

In the past several months, there has been great public angst concerning the industrial loan bank issue. To be fair, it is part of a broader debate concerning bank ownership that has gone on at least since the Glass-Steagall Act in 1933[1] and, we thought, was settled with the passage of the Gramm-Leach-Bliley Act of 1999.[2] Fundamentally, the concerns of policymakers should be centered on the proper activities of a bank that will accept funds from the public in the form of deposits. Regrettably, it seems to have instead evolved into a debate over who can own a bank, and, worse, it seems to have devolved into a process of presenting innuendo and half-truths that do little to inform the issue and arguably conceal motives designed to eliminate or curb potential competition in the delivery of important financial services to the public.

In listening to one side of this debate, one might conclude that some great evil will result from mixing banking and commerce were commercial companies allowed to own industrial loan banks; and that Congress unintentionally left a "loophole" that may be exploited by commercial companies that will somehow endanger our economy. These first two assertions are simply historically inaccurate,[3] and ignore the fact that throughout

[1] The Glass-Steagall Act separated to a limited degree investment and commercial banking. The separation was never absolute; indeed, it was substantially eroded by regulatory interpretations by the Federal Reserve in the 1980's and 1990's. Whatever separation remained was essentially eviscerated by the adoption of the Gramm-Leach-Bliley Act in 1999.
[2] Pub. L. 106-102, 113 Stat. 1338 (1999).
[3] I will not repeat the arguments that have been presented before Congress many times in the past on the first two assertions. 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 the

our history there have long been affiliations between banks and commercial firms. Indeed, many of these affiliations have been expressly blessed by Congress. We should be clear on this point. Such affiliations have always existed. Congress has chosen to limit certain of them from time to time, but the Bank Holding Company Act,[4] the Competitive Equality Banking Act,[5] the Federal Deposit Insurance Corporation Improvement Act[6] and the Gramm-Leach-Bliley Act[7] each address, and bless, and regulate, commercial affiliations with banks.

Another assertion that has recently been made is that the unregulated owners of industrial banks would wreck havoc on our financial system given the lack of "comprehensive supervision" of the corporate owners of such institutions. This last proposition ignores the existing legal framework governing all financial institutions, including industrial loan banks, and ignores the substantial power and authority (and indeed belittles the capacity) of the FDIC to supervise, examine and enforce laws, rules and regulations that are intended to assure safety and soundness, as well as prevent abuses that might possibly arise from affiliations between banks and commercial affiliates.

It is this last assertion that I particularly wish to address, that somehow the lack of comprehensive supervision poses a threat to our financial system. I make four major points in response:

"unintended loophole," Congress has extensively considered industrial loan 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.

[4] 12 U.S.C. § 1841(c), where Congress has defined the term "bank" to exclude a variety of institutions that may be owned by commercial firms.

[5] See 12 U.S.C. § 1841(c)(ii)(H)(2), where so-called "non-bank banks" were grandfathered. See Competitive Equality Banking Act of 1987, Pub. L. 100-86, 101 Stat. 554-557, 563, 584 (1987).

[6] See Sec. 24 of the Federal Deposit Insurance Act, as added by Act of December 19, 1991 (Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. 102-242, § 303(a),105 Stat. 2236, 2249-2253 (1991), where the FDIC was granted power to allow commercial activities by state chartered banks.

[7] See particularly the provisions of 12 U.S.C. 1843(k) allowing a variety of commercial activities by financial holding companies – in particular merchant banking powers permitting ownership of any commercial entity.

· First, industrial loan 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;[8] Regulation O, governing loans to officers, directors or their related interests;[9] capital requirements;[10] the Prompt Corrective Action 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;[11] and all of the other laws, rules and regulations that promote safe and sound banking in this country.

· 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,[12] 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. Given the magnitude of the 1980's financial debacle and the great concerns in Congress that it never happen again, we at the FDIC at that time worked closely with members of this Committee and others in Congress with the clear intention to give the FDIC and the other bank regulators all of the supervisory and enforcement powers they would ever need to protect the banking system. We wanted to be sure that no future banking failures would be the result of a lack of FDIC authority and tools to address threats to a bank's safety-and-soundness, including threats that might arise from its nonbanking affiliates.

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[8] 12 U.S.C. §§ 371c, 371c-1.
[9] 12 C.F.R. § 215.1 et seq.. See 12 U.S.C. § 1817(k)
[10] 12 C.F.R. § 325.1 et seq.
[11] 12 U.S.C. § 1831o. See also 12 C.F.R. § 325.101 et seq.
[12] The Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. 101-73, 103 Stat. 183 (1989), extensively revising 12 U.S.C. § 1818.

Importantly, all of these enforcement powers apply with full force to an industrial loan bank, as well as to any officer, director, controlling shareholder or "any other person . . . who participates in the conduct of the affairs of an insured depository institution."[13] There is no question that to the extent that either the corporate owner of an industrial loan bank or any affiliate of that owner engages in any violation of law, rule or regulation applicable to the industrial loan bank, or has engaged, is engaging or is about to engage in an unsafe or unsound practice relating to the industrial loan 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,[14] but also requiring that the condition be remedied and restitution made.[15] Civil money penalties up to one million dollars per day can be imposed,[16] and individuals can be removed from their positions and precluded from having any involvement not only with the industrial loan bank but with *any* insured depository institution.[17] The FDIC can also restrict the activities of the industrial loan bank or any affiliate participating in its affairs, can withdraw the deposit insurance of the industrial loan bank[18] and take any other action it "deems appropriate" in the event of a violation of law, rule or regulation, including in my opinion even forcing the divestiture of the industrial loan bank by its owner.[19]

· Third, I can attest from experience that the FDIC regularly and vigorously exercises these powers. The FDIC routinely requires an independent, fully

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[13] See 12 U.S.C. § 1813(u) (definition of "institution-affiliated party") and 12 U.S.C. §1818.
[14] 12 U.S.C. §§ 1818(b), (c).
[15] 12 U.S.C. § 1818(b)(6).
[16] 12 U.S.C. § 1818(i).
[17] 12 U.S.C. § 1818(e).
[18] 12 U.S.C. § 1818(a).
[19] 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 an insured depository institution or any institution-affiliated party." 12 U.S.C. § 1818(b)(7). Finally, the FDIC has been granted "all 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 loan bank and its parent were the relationship between the two create an unsafe or unsound condition.

functioning board of directors designed to assure that the industrial loan bank stands on its own and is not merely an arm of its corporate owner. The industrial loan 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 loan 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 loan 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.

· Fourth, the experience of the FDIC with respect to industrial loan 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 <u>two</u> failures of FDIC-insured industrial loan banks owned by holding companies.[20] These holding companies were not commercial (i.e., a non-financial) enterprises. 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 that operated in holding company structures, many of which cost the FDIC billions of dollars. The list is long and

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[20] The two institutions were Pacific Thrift and Loan (<u>see</u> Press Release, FDIC, FDIC Approves the Assumption of the Insured Deposits of Pacific Thrift and Loan Company (Nov. 19, 1999) available at http://www.fdic.gov/news/news/press/1999/pr9971.html) and Southern Pacific Bank (<u>see</u> Press Release, FDIC, FDIC Approves the Assumption of the Insured Deposits of Southern Pacific Bank (Feb. 7, 2003) available at http://www.fdic.gov/news/news/press/2003/pr1103.html). There were a series of small industrial loan 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." FDIC, <u>The FDIC's Regulation of Industrial Loan Companies: A</u>

sobering – Continental Illinois, First Republic, First City, MCorp, Bank of New England, and so on – all of which were subject to the much-vaunted "consolidated supervision" by the Federal Reserve as the holding company regulator that is offered as a cure for something that hasn't proven to be a problem.

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 loan 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.[21] 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 loan banks are not subject to the same degree of consolidated supervision that bank holding companies must endure,[22] 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.

As former Federal Reserve Chairman Alan Greenspan once observed:

Historical Perspective, Supervisory Insights, Summer 2004, [herinafter Industrial Loan Companies] http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/industrial_loans.html.

[21] 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 Industrial Loan Companies, supra note 20.

[22] GAO, GAO-05-621 Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority, Report to the Honorable James A. Leach, House of Representatives (2005) available at http://www.gao.gov/new.items/d05621.pdf.

> The case is weak, in our judgment, for umbrella supervision of a holding company in which the bank is not the dominant unit and is not large enough to induce systemic problems should it fail.[23]

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[24] or solely in financial activities as deemed permissible by the Federal Reserve.[25]

It may be useful to review a statement made by a former member of the Federal Home Loan Bank Board who served during the thrift crisis period of the late 1980's and who is now a professor at NYU, Lawrence White. In discussing the crisis, he noted the benefits of diversified ownership of thrifts: "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."[26]

The supposed "ills" that would result from the continued use of industrial loan banks to deliver financial services are mere shibboleths. Critics assert that an industrial loan 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:

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[23] Financial Services Restructuring: Hearing Before the Subcomm. On Capital Markets, Securities and Government Sponsored Enterprises of the H. Comm. on Financial Services, 105th Cong. (1997) (testimony of Alan Greenspan, Federal Reserve Chairman).

[24] 12 U.S.C. § 1843(c)(8), the provision that primarily defines the permissible direct and direct activities of bank holding companies.

[25] 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.

[26] Lawrence J. White, *The S&L Debacle, Public Policy Lessons for Bank and Thrift Regulation* 242 (1991).

· Existing laws preclude use of the industrial loan bank to provide any favorable accommodation to the commercial affiliate. Using an industrial loan 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. 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 its securities affiliate 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 a bank located in a small community 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.[27]

· Finally, if we were really concerned about the potential dangers of mixing banking and commerce, we should roll back the merchant banking powers granted banking organizations,[28] eliminate the FDIC's power to approve commercial

[27] 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.
[28] 12 U.S.C. § 1843(k)(4)(H).

activities for banks[29] and perhaps even strip commercial lending powers from banks, as there are few relationships giving a bank more power over, and a greater interest in, a commercial enterprise than to be the primary source of its funding.

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 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 loan bank model represents only one of many options available for delivering financial services and products. 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 loan 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.

And we should be very clear about a fundamental point. ***Throughout our history to now, there have always been, and federal law has always allowed, affiliations between "banking" and "commerce."*** In our modern era, these relationships have been carefully considered, and accompanied by a statutory and regulatory framework assuring that our regulatory authorities have ample power to protect against abuses and problems.

[29] 12 U.S.C. § 1831a, as implemented by 12 C.F.R. § 362.1 et seq. 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

Moreover, both consumers and our economy have unquestionably benefited from the hundreds of banking-commerce affiliations that have long existed, and continue to exist. Congress should consider very carefully the full implications of any change in law that could choke off these affiliations and deny our financial system the flexibility and innovation that it always has had in the past. It would indeed be unwise to roll back the clock by taking steps to limit healthy and beneficial competition under the guise of advancing an idea that may have an attractive rhetorical resonance, but in fact is simply irrelevant to the issue at hand.

Thank you.

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characteristics and purchase and hold a variety of equity securities. See generally FDIC, Decisions on Bank Applications, http://www.fdic.gov/regulations/laws/bankdecisions/InvestActivity/index.html.