Testimony of

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Good morning, Chairman Bachus and members of the subcommittee, thank you for the opportunity to testify on Industrial Banks (IB) or as they are sometimes known Industrial Loan Corporations (ILC).

I am Edward Leary, Commissioner of Financial Institutions for the State of Utah. I have been involved with banking for thirty-two years. First as a community banker, then fifteen years in bank examiner positions with the Utah Department and for the last fourteen years as its Commissioner. I am pleased to be here today to share my views on this industry.

STATE CHARTER OPTION

As we all know, banking is integral to the fabric of economic life for all of us. Since the founding of this nation, states have chartered, regulated and supervised banking. The choice of charter remains a vital component of the check and balances of the dual banking system. State-chartered institutions in attempting to survive and meet the needs of their communities have fostered creativity and experimentation. The state-chartered institutions can innovate in a controlled environment that limits systemic risks. If a product, service, delivery mechanism or charter is fundamentally unsafe or unsound then those weaknesses may be exposed.

Today largely as a result of the states success in performing that role, the state charter remains a viable, though as a result of federal preemption, less appealing choice for banks, especially large interstate operations.

This capacity for innovation is particularly true of the industrial bank charter.

Another foundation of the dual banking system is the ability to freely choose the supervisory structure under which the insured entity operates. This foundation contributes to a competition in excellence among financial institution regulators. It is therefore vital that there is more than one approach to the regulation and supervision of financial institutions.

If I was invited to participate in this hearing today because of Utah's history and experience in chartering and regulating industrial banks, my view and statement is that industrial banks are the embodiment of what is right and proper in the dual banking system.

I would like to reference a thought-provoking statement from the former Federal Reserve Chairman, Alan Greenspan,

> *"A system in which banks have choices, and in regulations that result from the give and take involving more than one agency, stands a better chance of avoiding the extremes of Supervision." (No Single Regulator for Banks, Wall Street Journal, December 15, 1993.)*

WHAT THE PUBLIC POLICY DEBATE *SHOULD* BE

The fact that the subcommittee is having this hearing today reflects the reality that Utah's chartering and regulating of the industrial banks has been commensurate to the risk. Utah, in partnership with the FDIC, has jointly created a supervisory model for industrial banks that has evolved and will likely continue to evolve, but through twenty years of everyday application, it has worked, in that no Utah industrial bank has failed.

My belief is that this committee should not consider rewriting banking laws to address the desires of particular industry groups or trade associations whose desire is to suppress competition.

Nor should Congress change, much less outlaw a proven, successful regulatory structure because some groups have concerns about a particular applicant.

Testifying before Congress on financial services reform in 1987, the FDIC's then-chairman L. William Seidman argued that the public interest would be best served by,

> *"A ... financial services industry that met four objectives: the financial system should be viable and competitive, the banking system should be operated in a safe and sound manner, customers should realize benefits from enhanced competition, and the system should be flexible enough to respond to technological change. Consistent with these objectives, the regulatory and supervisory structure of banking should be the simplest and least costly one available.*
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> *The question facing policy makers then was - and continues to be - whether these objectives can be met without restricting the ability of banks to choose the corporate structure that best suits their business needs. As Seidman noted:*
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> *The pivotal question . . . is: Can a bank be insulated from those who might misuse or abuse it? Is it possible to create a supervisory wall around banks that insulates them and makes them safe and sound, even from their owners, affiliates and subsidiaries? If so, then the banking and commerce debate should focus on how affiliations should be regulated so that the public interest is met." (FDIC Banking Review, January 2005, The Future of Banking in America, The Mixing of Banking and Commerce: Current Policy Issues, Volume 16, No. 3.)*

I urge this committee and Congress to focus on the adequacy of the current regulatory processes conducted by the State of Utah and the FDIC. In the absence of a demonstrated example of regulatory failure, there is no fundamental, underlying reason for a public policy change.

If, in the future, shortcomings are identified, an amendment may be considered without outlawing a class of banks that have operated for over a century without harming competitors, consumers or the deposit insurance system. Believe me, if I am still the Commissioner when a shortcoming in our regulatory process is identified, it will be corrected, long before any legislative body could take action. The states and the FDIC have developed prudential standards that are in place today.

UTAH'S REGULATORY STRUCTURE & EXPERIENCE IN PARTNERSHIP WITH THE FDIC

Utah has been chartering industrial banks since the 1920s. In 1986, Utah law was changed to require Federal Deposit Insurance for all industrial banks.

Like most state banking departments, Utah regulates all types of state-chartered depository institutions, including banks, industrial banks and credit unions. The Utah department also has jurisdiction over many non-depository activities. The Utah department is entirely funded from assessments to the financial institutions we regulate through a restricted account that can only be appropriated to the department.

As state-chartered, FDIC insured institutions, industrial banks are currently operating in the states of Utah, California, Colorado, Hawaii, Indiana, Nevada and Minnesota. No state permits industrial banks to engage in activities that are not permissible for other state-chartered banks.

Industrial banks are subject to the same banking laws and are regulated in the same manner as other depository institutions. They are supervised and examined both by the states that charter them and by the FDIC. They are subject to the same safety and soundness, consumer protection, deposit insurance, Community Reinvestment Act, and other requirements as other FDIC-insured banks. However, special emphasis is placed on Federal Reserve Regulation W and Sections 23 A & B of that Regulation which closely regulates all parent and affiliate company transactions to ensure that there is a limit to the amount of "covered transactions" and an "arms length" basis for all transactions.

A Utah industrial bank is required to maintain the minimum amount of capital required by its federal deposit insurer, but the Commissioner may require a greater amount of capital.

The department has and will continue to defend (in partnership with the FDIC) our regulation and supervision of the industrial bank industry. The department takes its supervisory role seriously. It is an active participant with the FDIC in all industrial bank examinations and targeted reviews wherever they are conducted in the country. Our

examiners are participating in large loan exams (reviewing loans and lines-of credit in the $100's of millions), capital market examinations, trust exams, information system exams, consumer compliance and community reinvestment exams and bank secrecy act and anti-money laundering exams.

Utah believes it is a full partner with the FDIC in regulating, supervising and examining this industry. As proof of that fact, Utah is one of the very few states in the country performing CRA/Compliance examinations. Utah conducts most of these examinations jointly with the FDIC or Federal Reserve. To solidify this relationship with the FDIC, Utah signed a written agreement in January of 2004. Since that time Utah has participated on almost all CRA/Compliance examinations conducted by both federal agencies.

Utah is participating with the FDIC in the Large Bank Supervision Program for four industrial banks: Merrill Lynch Bank USA, UBS Bank, American Express Centurion Bank and Morgan Stanley Bank. The supervision of these large banks is coordinated by a full-time relationship manger for the State as well as the FDIC.

A team of examiners and specialists from Utah and the FDIC conduct targeted reviews in areas such as: commercial and retail credit, capital markets, bank technology, asset management, and compliance and they track the quality and quantity of risk management procedures. I think it is noteworthy that in June, fifteen examiners from Utah completed a three week targeted examination in Chicago as part of a loan review and analysis of wholly-owned subsidiaries for one of the large industrial banks. This type of activity is no longer extraordinary. Utah is doing this kind of examination on a routine basis.

The large bank program allows the State and FDIC to develop a more thorough knowledge of the bank than is possible through the traditional regime of periodic, discrete examinations. Over the three years Utah has been involved in this program, we have developed, tested, and refined this supervisory approach expressly to address the special financial and compliance challenges posed by bigger, more complex and to some degree globally positioned banks.

Some industrial banks tend to specialize in specific banking activities such as credit card, home mortgage, automobile, agricultural, loans secured by brokerage accounts or small business lending. This specialization has resulted in critics challenging the safety and soundness of these institutions. However, the FDIC has stated that industrial banks are no more a threat to the deposit insurance fund than commercial banks.

What Utah is engaged in is, "Bank-up or bottom-up supervision" of the industrial bank's parent company. The FDIC has more accurately described the regulatory structure as "Bank-Centric." This is not a new concept when examining a bank that is part of a holding company structure. Industrial banks based in Utah have been a "laboratory" for

those insured institutions owned by commercial entities. The evolving supervisory approaches of Utah and the FDIC have helped fine-tune processes and procedures that insulate an insured depository institution from potential abuses and conflicts of interest by a non-federally supervised parent. Critical controls have been developed as the result of cooperation between Utah regulators and the FDIC.

BANKING & COMMERCE

To me, the "separation of banking and commerce" is a debatable notion, not a reality. There have always been ways for commercial interests to affiliate with banks, and the ability of regulators to prevent abuses continues to evolve and strengthen.

Conversely, as the experience of the conventional banking industry shows, the wall separating banking and commerce is elastic.

A number of the members of this Committee will remember when the securities and insurance industries cited this principle as a mantra to keep banks from entering those lines of business.

Those of you who served in Congress at the time will recall that the Gramm-Leach-Bliley Act changed the test for bank activities from "closely related to banking" to those "of a financial nature" thereby, allowing banks to enter the securities and insurance industries (to the point where a few mega-banks dominate the former).

The elasticity of the test is demonstrated by the debate over whether real-estate brokerage is a financial activity.

I recognize that today's hearing is about the regulation of industrial banks, not a debate over banking and commerce. But I believe this argument should not be used as a stalking horse by those advocating an anti-competitive position to dismantle an entire segment of the financial services sector.

The industrial loan experience, like the experience of credit card banks, non-bank banks and other institutions with commercial parents, shows that fears about banking and commerce are unfounded. The history of industrial banks is a testament that the regulatory model has maintained the safety and soundness of these institutions. The track record demonstrates that banks can be safely operated as parts of diversified holding companies. Congress has already given the FDIC the authority it needs to take "prompt corrective action" to prevent abuses by the holding company and wall off the bank from risk. Utah examiners work with the FDIC to examine the banks and holding company affiliates that touch the bank.

EXAMINE THE FACTS IN A WORST CASE SCENARIO

In this discussion and others the worst case scenario that detractors have postulated is that of a holding company filing bankruptcy or getting into financial difficulty. The reality is that Utah and the FDIC have experienced both. While no regulator relishes stressful circumstances, we can state that we weathered the storm. Utah has had large corporate parents of industrial banks encountering financial difficulties, and in one instance the ultimate parent company filed for bankruptcy protection.

The background and outcome were well described by the FDIC in the January 2005, *FDIC Banking Review, The Mixing of Banking and Commerce: Current Policy Issues,*

> *"The bankruptcy of the corporate owner of an ILC - Conseco Inc - but not of the ILC itself illustrates how the bank-up approach can effectively protect the insured entity without there being a BHC-like regulation of the parent organization. Conseco Inc. was originally incorporated in 1979 as Security National of Indiana Corp. After several years of raising capital, it began selling insurance in 1982. Security National of Indiana changed its name to Conseco Inc. in 1984, after its 1983 merger with Consolidated National Life Insurance Company. Conseco Inc. expanded its operations throughout the 1980s and 1990s by acquiring other insurance operations in the life, health, and property and casualty areas. Conseco Inc. was primarily an insurance company until its 1998 acquisition of Green Tree Financial Services. A diversified financial company, Green Tree Financial Services was one of the largest manufactured-housing lenders in the United States. Upon acquisition, it was renamed Conseco Finance Corporation. Included in the acquisition were two insured depository charters held by Green Tree Financial Services - a small credit-card bank chartered in South Dakota and an ILC chartered in Utah. Both of these institutions were primarily involved in issuing and servicing private-label credit cards, although the ILC also made some home improvement loans. The ILC - Green Tree Capital Bank - was chartered in 1997 and changed its name to Conseco Bank in 1998 after the acquisition. Conseco Bank was operated profitably in every year except the year of its inception, and grew its equity capital from its initial $10 million in 1997 to just over $300 million in 2003. Over the same period, its assets ballooned from $10 million to $3 billion.*
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> *Conseco Bank was supervised by both the Utah Department of Financial Institutions and the FDIC. Despite the financial troubles of its parent and the parent's subsequent bankruptcy (filed on December 18, 2002), Conseco Bank's corporate firewalls and the regulatory supervision provided by Utah and the FDIC proved adequate in ensuring the bank's safety and soundness. In fact, $323 million of the $1.04 billion dollars received in the bankruptcy sale of Conseco Finance was in payment for the insured ILC - Conseco Bank, renamed Mill Creek*

Bank -which was purchased by GE Capital. As a testament to the Conseco Bank's financial health at the time of sale, the $323 million was equal to the book value of the bank at year-end 2002. Thus, the case of Conseco serves as an example of the ability of the bank-up approach to ensure that the safety and soundness of the bank is preserved."

In another case, TYCO, a large parent company of a Utah industrial bank called CIT Online Bank encountered financial difficulties and decided to spin the industrial bank group off in an initial public offering which was approved and completed. In spite of TYCO's financial difficulties, the Utah industrial bank continues operations today as CIT Bank.

HOLDING COMPANY SUPERVISION

There is no single "right" way to oversee entities that own a bank. The bank holding company model works well for companies whose principal business is limited to banking – it was devised at a time when bank holding companies were permitted to do nothing else. The existing industrial bank supervisory process works well. Utah thinks it is the *superior* model for holding companies whose principal business may not be banking.

What has received no coverage in the current debate is the fact that industrial bank oversight by the states and the FDIC is supplemented by holding company oversight by financial regulators other than the Federal Reserve. The Securities and Exchange Commission (SEC) and the Office of Thrift Supervision (OTS) have regulatory oversight over many holding companies with Utah industrial bank subsidiaries. They have approximately 75% of industry assets under their jurisdiction. If the Federal Reserve's holding company's supervision of UBS Bank USA and Universal Financial Corp. (owned by CitiGroup) assets are included that brings the industry's oversight by federal regulators to 90% of Utah assets as of March 31, 2006.

In Utah, the specifics are: UBS Bank USA with $19 billion in total assets as of March 31, 2006, the second largest industrial bank and Universal Financial Corp. with $535 million in total assets, are both subsidiaries of Financial Holding Companies subject to Federal Reserve jurisdiction. Many other large industrial banks including: American Express Centurion Bank with $14 billion in total assets, GE Capital Financial with $2 billion in total assets, Lehman Brothers Commercial Bank with $3 billion in total assets and Merrill Lynch Bank USA with $62 billion in total assets all have Federal Savings Bank affiliates and therefore their parent companies are also subject to the jurisdiction of the OTS. Additionally, in a Consolidated Supervised Entity environment the holding companies of Goldman Sachs Bank, Lehman Brothers Commercial Bank, Merrill Lynch Bank USA and Morgan Stanley Bank with $11 billion in total assets are subject to the jurisdiction of the SEC.

Not included in the totals above but consideration should be given to three additional Utah industrial banks: Advanta Bank with $1.6 billion in total assets, Target Bank with $12 million, and World Financial Capital Bank with $196 million in total assets, all of which have sister national banks chartered by the Office of the Comptroller of the Currency (OCC).

In this discussion, I think we need to keep in perspective that the entire industrial loan industry, even with its growth during the last twenty years, is only approximately 1.5% of banking assets.

The parent companies of the vast majority of industrial bank assets are engaged exclusively or predominantly in financial services activities. These include: Advanta, American Express, Citigroup, Merrill Lynch, Morgan Stanley and UBS. Other industrial banks are owned by diversified companies, such as General Electric and GMAC which engage in both financial and non-financial activities. Some are controlled by companies primarily engaged in commercial or industrial activities, such as BMW and Volkswagen. However, both BMW and Volkswagen have extensive bank operations in Europe.

It should be noted that the important fact of other federal agency oversight of industrial bank parents was given scant attention in the GAO's report on Industrial Loan Corporations. The GAO report also did not uncover a single example of the regulatory failure, or a problem that could have been averted with a different form of holding company oversight.

While not subject to regulation as bank holding companies, industrial bank owners are subject to many of the same requirements as bank holding companies. As a result, safeguards already exist to protect these depository institutions against abuses by the companies that control them or activities of affiliates that might jeopardize the safety and soundness of the institutions or endanger the deposit insurance system.

For example, restrictions on transactions with affiliates in Sections 23A and 23B of the Federal Reserve Act apply to industrial banks and their owners. These provisions limit the amount of affiliate loans and certain other transactions (including asset purchases) to 20 percent of a bank's capital, and require that such loans be made on an arm's length basis. Thus, an industrial bank may not lawfully extend significant amounts of credit to its holding company or affiliates or offer credit to them on preferential or non-market terms. All loans by industrial banks to their affiliates must be fully collateralized, in accordance with Section 23A requirements.

Utah law establishes, besides all other jurisdiction and enforcement authorities over industrial banks, that pursuant to Section 7-8-16 each industrial bank holding company must register with the department and is subject to the department's jurisdiction. Also,

according to Section 7-1-501 of the Utah Code each industrial bank holding company is subject to examination and enforcement authority of the department.

Utah financial institutions, including industrial banks supported a fee increase bill during the last session of the Utah Legislature. This is important because it demonstrates how serious the industry is about supporting and maintaining quality regulation and supervision. The fee increase allows Utah to continue our tradition of excellence in supervision, in joint safety and soundness examinations, in specialty examinations and in training. The fee increase will allow Utah to hire five more financial institutions examiners bringing the total number of examiners to forty-two. The department will provide further training to the cadre of existing holding company examiners and increase the number of qualified examiners so that Utah can conduct, independently, if need be, holding company inspections of all financial institution holding companies registered in Utah.

Through its role as primary regulator of state-chartered nonmember banks including industrial banks, the FDIC provides the bank-centric regulatory alternative for organizations and individuals that choose not to be regulated by the Federal Reserve under a holding company structure. Thus, this model offers greater flexibility for corporate enterprise, while managing the risks posed by a mixing of banking and commerce. Without this alternative regulatory structure, the ability of the market to meet the demands of consumers could be severely restricted.

I struggle to understand why Congress would want to keep out well-capitalized innovative entrants to the market? While the banking system is becoming concentrated in the hands of a few large institutions with huge market power and system risk. I understand that the five largest banks are trillion dollar entities, which control a third of industry assets and deposits, and a fourth of all bank branches.

ADDITIONAL PRUDENTIAL SAFEGUARDS APPLIED TO INDUSTRIAL BANKS

The question then may be. Can a bank, regulated at the bank level, be insulated and isolated from parent company improprieties? The Federal Reserve has staked out the umbrella regulator role from the top down. Utah believes that regulatory scrutiny can also be accomplished from the bank up. At least in our mind, the case has not been made that it does not work. In fact the track record of Utah industrial banks after twenty years of dual supervision from the state and FDIC is that there is no extraordinary risk in doing so. However, I would be the first to add that the industry requires additional prudential safeguards. Supervising industrial banks is an evolving regulatory dynamic. As new issues arise and new lessons are learned, I suspect we will add new requirements.

This enhanced regulatory oversight is most evident in approval Orders of de novo industrial banks. The Order is where the majority of prudential safeguards are issued and remain in effect for the life of the institution. These Orders reflect generally higher capital standards and more regulatory attention to previously noted problems.

Today, all Utah industrial bank approval Orders contain the following:

> The board of directors shall be comprised of a majority of outside - unaffiliated directors, and those unaffiliated directors shall not serve on the board of any other FDIC insured depository institution. (I should note that these director independence requirements were imposed long before the Sarbanes Oxley Act of 2002.)
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> There shall be no change in the executive officers or in the board of directors as submitted in the application without the prior approval of the Commissioner for a period of three (3) years after the industrial bank commences operations.
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> Requires at a minimum an onsite President, Chief Financial Officer, and Chief Credit Officer with sufficient support staff with the knowledge, ability, and expertise to successfully manage the risks of the industrial bank, maintain direct control of the industrial bank, and retain the industrial banks independence from the parent company.
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> Within 30 days of receiving all required regulatory approval to operate as an insured Utah industrial bank, the industrial bank holding company shall register with the department by filing a registration statement as required by Utah law.

SUMMARY

Utah has been successfully regulating FDIC insured industrial banks for twenty years. Utah has established a record of safe and sound institutions with prudential safeguards in place that have prevented parent companies from exercising undue influence over the insured entity.

Utah's industrial banks are well capitalized, safe and sound institutions.

Utah's industrial banks are subject to the same regulations and are examined in the same manner as other banks.

Utah views our brand of regulation as tough but fair. An essential component of our brand of regulation is to require on-site management from bank-experienced people.

Utah and FDIC examiners have adapted as the industrial banks have evolved. For us, keeping up with new products, new financial instruments and new delivery mechanisms has been a regulatory challenge, but a challenge we have met with the shared resources of our regulatory partners, both state and FDIC.

In this discussion, the reality check is that the entire industrial loan industry, even with its growth of the last twenty years, is only approximately 1.5% of banking assets.
Utah's vision of the industrial bank industry was to advance and enhance the image of Utah and the state charter. The department envisioned Utah as a financial services center. In keeping with that vision, Utah expects financial institutions to be safe, sound, well capitalized and well managed. We expect the best corporate conduct by all industrial banks chartered in Utah. Utah also expects the best performance of ourselves as a regulator. It does not advance or enhance the state's image if we do not succeed.