Remarks by
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Utah Commissioner of Financial Institutions
before
Utah Association of Financial Services
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Good morning. As always, it is a delight to attend the Utah Association of Financial Services Convention. Thank you for extending an invitation.

STATE OBJECTIVE IN CHARTERING ILCs

A good place to begin is in asking the question, what is it that the State of Utah expects or desires when chartering a depository institution? My short answer is to better serve the credit needs of its citizens and provide a safe haven for deposits. One could argue that purpose is best accomplished by chartering and supporting local or community based institutions. Yes, but Utah has also been well served by operations and branches of large national banks within our state. A second purpose is to provide for economic development in terms of number of jobs and the vitality of commerce within the state. I submit that the Utah ILC industry responds to all of those objectives by helping meet the credit needs of Utahns, providing a safe haven for deposits and finally aiding in Utah's economic development. The ILCs provide unheralded prosperity for the state with the industry establishing a larger presence and impact each quarter.

Somewhat by design and somewhat by happenstance this industry came into being in our state in its current iteration. It has been a challenging and exciting development in Utah that has fostered improvements and diversification of financial products and services to a nationwide audience.

One could ask is the ILC a harbinger of the institution of tomorrow or is the ILC a risky experiment? Those questions probably await the long run for an answer. I am reminded of a quote attributed to the former Chinese leader Mao Zedong. A reporter once asked him about the impact of Napoleon on history? Mao's reply, "Too soon to tell."

A bank regulator once said that one of the lessons of the 80's was taking on too much risk in good times that planted the seeds of failure in down times. The question has been debated whether the new E-Commerce based economy voided the old banking maxim about staying within a defined geographic area for lending? The new E-Commerce seems to indicate that geographic considerations are no longer controlling but a risk to be compensated for in prudent business practices.

Should Utah persevere and prevail in establishing its place in the new electronic banking world? I have been told Utah is becoming the Delaware of the West. I am not comfortable with that moniker but believe Utah should be seeking a significant place in the banking environment of the future and especially within the new E-Commerce economy. I see no better vehicle to accomplish this than through the national advantage we enjoy though the ILCs.

UTAH-CHARTERED FINANCIAL INSTITUTIONS

Let me start by giving you current numbers for financial institutions in Utah. As of June 30, 2000, Utah's financial institutions' industry consists of 24 state-chartered and 9 national chartered banks with total assets exceeding $30 billion; 1 State-chartered, 2 federally chartered out of state and 1 federal in-state Savings Bank; 96 state-chartered Credit Unions and 43 federally chartered credit unions with total assets of approximately $6 billion; and finally 21 state-chartered industrial loans with total assets exceeding $41 billion.

The department has registered 1,883 Consumer Credit lenders, 2,037 Mortgage lenders, brokers, or servicers, 11 Independent Escrow Agents and 242 offices conducting Check Cashing or Payday Lending.

ILCs

I have passed out two handouts. The first lists the growth in Utah ILCs compared with other state-chartered institutions. The second is a summary of June 30, 2000 call reports listing total assets and applications pending. As you will note, the state has approved four applications which are awaiting FDIC action. We have reaccepted one additional application for a new charter and have commenced that process.

As is evident from the growth in total assets of ILCs and continuing new applications, the interest in ILCs continues. Last year, I told you fourteen companies were interested in ILC charters. This year I would still give you the same number still interested in ILC charters, not including the applications in process. As before, it is difficult to determine the level of interest or whether that interest will turn into an application.

BACKGROUND

It's not fair to say that regulators are pessimists by nature. In fact, I would think most bank regulators would likely describe themselves as fairly optimistic people. It's just that we are paid to be professional worriers. It's our job. We are always considering the, "What if?" scenarios. We are constantly preparing for economic downturns, stressing preparedness even in the good times. Although the good times have lasted a very long time for us, we are constantly asking how long can these good times last?

John G. Medlin, Jr. former CEO and Chairman of the Board of Wachovia stated, "The bottom line is that the fortunes of banks and their performance are determined largely by three factors. One is public policy. The second is the condition and performance of the economy. The third is management practices and internal management of those institutions."

I think most of you are aware of my other career as a 24-year naval reserve officer on active and reserve duty. As a result of that career, I studied military tactics and history first from a maritime perspective and eventually from a land-based orientation. I can tell you from my first days as a midshipman to my final days as the Naval Liaison Officer to the Utah National Guard. No profession spends more time than the military carefully studying and re-fighting past wars, identifying mistakes, distilling lessons for future campaigns, separating the strategies of enduring value from those soon to be irrelevant. My own conclusion is that this endeavor may not always be the best approach. The next campaign may be vastly different from the last, underlying motivations and principles may have changed.

No country spent more time than the French studying the tragic and costly debacle known as World War I. The French applied the lessons of that war, as they perceived them, built the largest and best equipped army in the world, and then put it behind impregnable barriers. When war came again 20 years later and France was attacked, on May 10, 1940, it was completely defeated and capitulated in about six weeks. What went wrong?

First, the Germans had spent just as much time studying the same campaigns of World War I and they arrived at different conclusions from the French. The Germans knew they could not fight static fixed emplacement war and win. They developed a new strategy called "Blitzkrieg," the lightening war with its emphasis on mobility. The French appeared to have fixated on the past they forgot that the next war might be different. There is no question that if World War I had been resumed in 1939- 40, the French would have been easy victors. Their fatal mistake was to forget that the next war might be a much different war - and it was.

In the banking crisis of the 1980s and early 1990s banking regulators were tested and from those experiences, we have learned lessons. Experience is a tough teacher - first you get the test - them you learn the lesson. My experience teaches me that chartering depository institutions is a challenge.

In the case of ILCs, higher prudential standards and more regulatory attention to problems are part of the lessons learned. There must be a balance struck between the institution's ability to innovate and develop profitable products and services and regulators charge to ensure safety and soundness. I believe we have thus far correctly identified a good balance.

I wish I could say with confidence what the next crisis in banking will be or what are the long term risk for the State of Utah in chartering ILCs. I cannot. Yes, there may be some similarities with specific identified problems of the past but there are also some differences. In fact, these differences might be so great as to render useless, or at best, questionable, a few of the lessons drawn from a study of the past.

Bill Siedman, the former Chairman of the FDIC concluded a commentary piece in a recent Bank Director magazine with the statement, "Who knows what the future may bring - and besides, (John M.) Keynes (the economist) advised us, 'in the long run, we all are dead.' Somehow, though I never seem to feel much better after that bit of philosophy."

At this point let me restate that I view my charge from Governor Leavitt to be a regulator first, cognizant of economic development opportunities second. My first priority is and always will be the safety and soundness of Utah financial institutions. I care about this industry. The department is the closest governmental supervisory agency to the citizens of the state. Angry, distraught depositors who came into our offices during the period when we were closing institutions have left a lasting impression on me.

MY CONCERNS

REGULATORY

The following are four regulatory concerns that need to be addressed.

I will NOT distinguish between state and federal regulator concerns. The regulators are unified in our goal of maintaining the safety and soundness of the ILCs. There may be a variance in degree of concern depending upon the particular issue but the unity of the concern I am confident in stating.

Lack of Management Control: I am specifically including the board of directors within the term management. The lack of autonomy from the corporate parent and/or affiliates is a problem that has been around since the beginning of the current version of the ILC industry. The first round of regulatory actions in the late 1980s and early 1990s was largely based upon lack of management control at the insured entity level.

The requirement that a majority of ILC directors be outside unaffiliated was spawned during this period in response to, and an attempt to provide a check and balance to this unsafe condition and practice.

What do we want? We want a board of directors comprising competent people of integrity. The board members must be active and provide direction and supervision to management. Second, we want a management team that is autonomous from the larger corporation; that acts at all times in the best interest of the depository institution; that demands accurate, reliable accounting records on-site upon which to base their decisions; that retains the credit underwriting policy and decision-making authority; that ensures all transactions with the parent corporation or affiliates passes the strictest arms-length scrutiny.

Two quotes from the handout given to every interested ILC applicant may serve to reinforce the point,

> *"The establishment of a Utah organization [is required] where autonomous decision-making authority and responsibility reside with the board and management such that they are in control of the ILC's activities and direction."*
>
> *"Utah-based management that has a demonstrated track record of knowledge, expertise and experience in operating a depository institution with products and services similar to that proposed for the ILC."*

In summary, I want to make this clear. The concern exists today. Lack of management control was largely the basis for supervisory action in a particular case and may be the basis for supervisory actions in the future.

Rapid Growth in Assets or Deposits: UNCONTROLLED rapid growth has always been a red flag to regulators. At the CSBS Annual Meeting in San Francisco held last May, FDIC Chairman Donna Tanoue noted that the Bank Insurance Fund lost money in 1999, for the first time since 1991. In both 1998 and 1999, the FDIC and state supervisors downgraded more state-chartered banks than they upgraded, and Chairman Tanoue said that "management" component downgrades are now outpacing upgrades by a rate of two to one. Chairman Tanoue described several characteristics of four recent, costly failures, and noted that the FDIC has begun to see some of these indicators even in healthy institutions:

- Rapid growth, outstripping infrastructure, financial and human resources;
- Unrealistic valuation of residuals from securitization, creating illusory capital;
- Nontraditional (subprime) lending without sufficient controls or expertise;
- Dramatic changes in the bank's business plan, often based on unrealistic assumptions, often following a change in control;
- Third-party servicing arrangements that delegate too much authority to an outside vendor, combined with insufficient supervision and audit controls; and, as always,
- Fraud.

By their very nature, the products and services traditionally offered by an ILC to a national customer-base would result in very large balance sheet amounts. I emphasize that regulators are always concerned with extraordinary growth because of its inherent challenge to management to maintain control. Examiners will be evaluating how well management is maintaining control in the growth environment.

Adequacy of the Allowance for Loan and Lease Losses: As will probably always be the case, the adequacy of the allowance account continues to be an issue at most examinations. I thought a short review of the most important elements from the FDIC Division of Supervision Examiners Manual would be helpful.

The management of a financial institution is responsible for establishing and maintaining an allowance for loan and lease losses that is adequate to absorb estimated losses inherent in the loan and lease portfolio as of the financial statement date. The manual also references that the allowance account should be sufficient to absorb estimated losses associated with off-balance sheet credit instruments.

It is the responsibility of the board of directors and management to evaluate and ensure appropriate provisions are made, at least quarterly. Board and management are expected to:

- Establish and maintain a loan review system that identifies, monitors, and addresses asset quality problems in a timely manner.

- Ensure the prompt charge off of loans, or portions of loans, deemed uncollectible.

- Ensure that the process for determining an adequate allowance level is based on comprehensive, adequately documented, and consistently applied analysis.

Management's analysis of an adequate reserve level should be conservative to reflect a margin for the imprecision inherent in most estimates of expected credit losses. When determining an appropriate allowance, primary reliance should normally be placed on analysis of the various components of a portfolio, including all significant credit reviewed on an individual basis. When analyzing the adequacy of an allowance, portfolios should be segmented into as many components as practical. Each component should normally have similar characteristics.

Sub Prime Lending: My fourth concern is one that I covered last year but remains an issue this year, sub prime lending. I again refer you to guidance given in the Interagency Guidelines on Sub-Prime Lending dated March 4, 1999. Advice? Comply!

CONGRESSIONAL

At the Department, we attempt to keep in close contact with our Congressional delegation, especially Sen. Bennett. We are sensitive to Senate Banking Committee items that might affect the Utah ILCs. I again make a plea to all of you, particularly those with liaison offices in Washington, D.C., to keep an eye out for all of us and if you are aware of any issue that has arisen or might arise affecting Utah ILCs to give us notice. We appreciate all the help we can get.

As a result of the growth in number and size of the Utah ILC industry it was unavoidable that Congress became aware of what we are doing. I am sure most of you have been informed of my conversations and meetings with House Banking Committee Chairman Leach concerning Utah ILCs since passage of the Gramm-Leach-Bliley Act last year. I think it is safe to say that Chairman Leach remains philosophically concerned with the merging of banking and commerce and that the Utah ILCs go further that he would like. I do not believe that anything the state or the industry says will dissuade him from that view. What is a possible outcome of this concern? The House may call for a hearing on ILCs and propose legislation to deal with the issue. An additional unknown is the fact that Rep. Leach will not be the Banking Committee Chairman next year and the Committee agenda is largely controlled by the Chairman.

The good news appears to be that Senate Banking Committee Chairman Gramm is not expressing concern about the ILC industry.

My sense is that the Congressional spotlight and scrutiny are upon the ILCs. Vigilance and prudence are the order of the day for the state and the industry. We will have to watch events in Washington very carefully.

The Federal Reserve in Washington, D.C. is also watching the industry and is making its concerns that the ILCs are not subject to their umbrella supervision known.

It was an interesting occurrence that the transfer of billions in mutual fund accounts held by Merrill Lynch customers to FDIC insured deposits, was used by the FDIC in it campaign to reform the deposit insurance premium system. The result has been that the Utah ILCs industry has been mentioned in the deposit insurance reform debate which has led to even more people becoming aware of the industry.

Let me conclude by saying that there are many more issues that I could address but time does not permit. It seems to me that it is incumbent upon the industry to perform well as insured depository institutions and set a national standard for regulatory compliance. The Department's door remains open to the industry and we seek your success within safety and soundness parameters.

Thank You.

UTAH DEPARTMENT OF FINANCIAL INSTITUTIONS

Growth in Utah Industrial Loan Corporations (ILCs)

Compared with Other State-Chartered Institutions

As of June 30, 2000

INDUSTRY COMPARISON:

Industry	No. of Institutions	Total Assets (In billions)
ILCs	21	$ 41.3
Credit Unions	96	5.0
Banks	24	2.9
Savings Banks	1	.2
Total State-Chartered	142	49.4

GROWTH OF ILC INDUSTRY:

Year End	No. of ILC Charters	Total Assets
1992	17	$ 1.0
1993	15	1.2
1994	14	1.9
1995	15	3.0
1996	15	13.0
1997	18	15.4
1998	20	17.8
1999	20	29.7
2000 (June 30)	21	41.3

LARGEST STATE-CHARTERED INSTITUTIONS BY INDUSTRY: (exceeding $1 billion in total assets)

ILCs:		Total Assets
American Express Centurion Bank		$ 14.9
Merrill Lynch Bank USA		14.8
G E Capital Financial		3.1
Providian Bank		2.8
Conseco Bank		1.6
Banks		
Bank of Utah	(Largest UT-chartered)	.4
Credit Unions		
America First Credit Union		1.7

UTAH DEPARTMENT OF FINANCIAL INSTITUTIONS

Utah Industrial Loan Corporations

as of

June 30, 2000

(Figures in Millions)

NAME		TOTAL ASSETS
Advanta Bank		$ 1,062
American Express Centurion Bank		14,905
American Investment Financial	(Leucadia)	78
Associates Capital Bank		133
BMW Bank of North America		914
Conseco Bank		1,639
ECharge Bank		4
Escrow Bank USA	(GMAC Commercial Mortgage)	14
First USA Financial		178
G.E. Capital Financial		3,092
Merrick Bank		279
Merrill Lynch Bank USA		14,799
Morgan Stanley Dean Witter Bank		575
Pitney Bowes Bank		102
Providian Bank		2,748
Republic Bank		43
Transportation Alliance Bank	(Flying J)	35
Universal Financial Corp	(Citigroup)	461
Webbank		30
Volvo Commercial Credit		10
Wright Express Financial		232
TOTAL ASSETS	(21 Charters)	**$41,333**

APPLICATIONS PENDING: (through 8-25-00)

Celtic Bank (application accepted 7-31-00)

CIT - Online Bank (CIT Financial), Utah approval 6-20-00

First Electronic Bank (Fry Electronics), Utah approval 3-31-00, FDIC approved 8-25-00

Upland Bank (American Business Financial Services), Utah approval 8-7-00

YourBank.Com (Gateway), Utah approval 7-7-00