TESTIMONY OF
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ON BEHALF OF
THE SECURITIES INDUSTRY ASSOCIATION

BEFORE THE
HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

"ILC's – A REVIEW OF CHARTER, OWNERSHIP, AND SUPERVISION ISSUES"

JULY 12, 2006

Introduction

Mr. Chairman and members of the subcommittee, I am George Sutton and I appear today on behalf of the Securities Industry Association (SIA). [1]

I am an attorney with the firm of Callister, Nebeker and McCullough in Salt Lake City, Utah. My firm represents SIA on state issues in Utah, along with many commercial and community banks and banking trade associations. We also represent about half of the industrial loan banks ("industrial banks") based in Utah, including several of the banks owned by SIA members. Prior to commencing my law practice I served briefly as the CEO of an industrial bank. Before that I served for over nine years with the Utah Department of Financial Institutions. From 1987 to 1992 I was the state's Commissioner of Financial Institutions.

At year-end 2005, industrial banks owned by securities firms held more than 75 percent of the $120 billion in assets held by industrial banks in Utah. The continued viability of the

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[1] The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals and its personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift and pension plans. In 2005, the industry generated an estimated $322.4 billion in domestic revenue and an estimated $474 billion in global revenues. (More information about SIA is available at: www.sia.com.)

industrial loan bank charter is critically important to the securities industry. We are grateful for the opportunity to explain why any attempt to alter the industrial loan bank charter would seriously impair our industry's ability to compete.

It might be helpful at the outset to give you a short history of industrial banks. They first developed in the late 19th and early 20th centuries as small finance companies to provide loans for industrial workers. They were authorized in several states, some of which allowed them to take uninsured deposits. Utah first authorized them in 1927. Over the years, industrial banks in some states developed into depository institutions offering all the services of a bank except demand checking accounts. By the 1980s, these institutions in some states had become one among many kinds of depository charters utilized by a growing number of diversified companies in the financial services markets. When Congress enacted the Competitive Equality in Banking Act of 1987 ("CEBA"), it added language that codified this group of non-traditional bank charters. The Act made industrial banks exempt from the Bank Holding Company Act if they were chartered in states that required FDIC insurance as of March 1987.

This industrial bank exemption was retained in 1999 when Congress enacted the Gramm-Leach-Bliley Act ("GLBA"). GLBA also modified a restriction that had prevented industrial banks from allowing "interday overdrafts" on behalf of affiliates, by limiting that restriction to affiliates that engage in non-financial activities. This explicit recognition of industrial loan banks in GLBA is inconsistent with the claim that the statute was intended to prohibit affiliation between banks and non-banking entities.

The industrial banks operating in Utah today provide ample evidence of the viability of this charter. Over the past 20 years, the current generation of industrial banks has developed into one of the strongest, safest and soundest group of banks that ever existed. Group capital and earnings are well above average. There have been no failures, even in one instance when an industrial bank's holding company became bankrupt. Industrial banks have had an exemplary record of service to their customers and the community. For example, nearly 40 percent of the Utah industrial banks examined by the FDIC for compliance with the Community Reinvestment Act has received "Outstanding" ratings, a remarkable record of achievement.

Securities Firms' Ownership of Industrial Loan Banks

The first SIA member-owned banks were organized in the 1980s. Several kinds of limited purpose charters were utilized including industrial loan banks, "non bank banks", credit card banks and federal savings banks.

Today, SIA member-firms have essentially three choices with regard to ownership of a bank:

(1) They can operate national or commercial bank subsidiaries by divesting non-financial businesses (and non-conforming financial activities) and organize as financial holding companies under consolidated regulation by the Federal Reserve.

(2) Firms that have federal savings bank affiliates that were grandfathered under GLBA can operate as "unitary thrift holding companies" under consolidated supervision of the Office of Thrift Supervision. Several SIA member firms fall into this category.

(3) Firms can operate industrial banks or other limited bank charters (e.g. grandfathered "non-bank banks", credit card banks) and become "consolidated supervised entities"

examined at the holding company level by the Securities and Exchange Commission (SEC). Today securities firms predominantly utilize this option.[2]

Securities firms own the largest industrial banks, and collectively, control industrial loan banks that hold more than 75 percent of total industry assets and deposits.[3] Because securities firms typically engage in activities that are not permissible for bank holding companies, they cannot acquire full service commercial banks without exiting businesses that account for substantial segments of their revenues, which many SIA members consider critical to well-functioning capital markets. Ownership of industrial banks has therefore become the principal means of providing banking services for these firms.

Industrial banks operated by securities firms are primarily focused on two services. One is to provide better "sweep" options for individual clients with idle funds in their brokerage accounts (e.g., proceeds from dividend payments or securities sales). In the past these funds were usually swept into independent money market funds that were neither federally insured nor affiliated with the broker. The second purpose is to provide commercial lending and other banking services to securities firms' institutional clients. Investment banking customers have increasingly demanded full service from their financial services providers, whether those providers are securities firms or commercial banks. Rather than maintaining multiple lending and securities relationships, these clients want to deal with one provider that can take care of all of their financial needs and price their services and products accordingly. To compete in this

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[2] A number of SIA member-firms control other types of depository institutions that, like industrial banks, may be owned by entities that are not bank holding companies (e.g., credit card banks, thrift institutions, and grandfathered "non bank banks").

[3] When combined with the assets and deposits of industrial banks owned by other financial services firms, such as American Express and Advanta Corp., the financial services sector of the industrial loan bank industry comprises over 90 percent of the industry.

space, securities firms need to offer banking services and match banks' costs of funds. The best way to do that is to organize their own banks.

Regulation of Industrial Banks and their Owners

With that background, let me turn now to one of the key issues in the current debate over industrial banks – the misconception that industrial banks are not adequately regulated. This is primarily linked to the fact that the Federal Reserve does not regulate industrial bank holding companies. However, a close examination of the facts confirms that both the banks and their holding companies are adequately regulated under the industrial bank model.

First, we should be clear that industrial banks themselves are fully regulated in the same manner as other banks by the same regulators applying the same laws, standards and procedures. Industrial banks cannot engage in banking activities unless they do so under the same rules as any other bank. Under the Federal Deposit Insurance Act, no industrial loan bank can engage as principal in any activity not authorized for a national bank.

The industrial bank model is actually stronger in some respects than the requirements applicable to a traditional bank. For example, because industrial banks are usually affiliated with larger diversified holding companies, there is heightened concern about compliance with Sections 23A and 23B of the Federal Reserve Act and other laws and requirements relating to affiliate transactions. To help insulate the bank from any undue influence by an affiliate, state and federal regulators impose additional requirements on an industrial bank to ensure its independence. As applied today, an industrial bank can directly or indirectly finance sales or transactions with an affiliate only if the loan is secured dollar for dollar with a dedicated cash deposit in the bank or U.S. government securities.

A Utah industrial bank is required to have independent management and boards. Boards are required to have a majority of outside directors and audit committees are required to consist solely of outside directors headed by someone qualified in auditing and accounting. Officers are required to have prior successful experience in the kinds of positions they hold in the bank. Recently regulators began to require all outside directors to have substantial prior experience in banking, accounting, regulation or another expertise relevant to the bank's business and operations. Several former Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC) officials and examiners currently serve as directors and officers of industrial banks.

Holding Company Supervision of Securities Firms with Industrial Banks by FDIC/State Regulators

Securities firms with industrial bank subsidiaries are subject to multiple levels of holding company supervision. Like other industrial bank owners, securities firms are regulated by the FDIC and the bank's state regulator under the FDIC's "bank centric" supervisory model. Under this model, the FDIC has the following authority over the bank's parent and affiliates:

- To approve any restructuring or reorganization of the parent that affects control of the bank.
- To require production of any information and directly examine the entity.
- To issue cease and desist orders enforceable in federal court against any institution affiliated party regarding any action or activity that would threaten the safe and sound operation of the bank or violate any law, rule regulation, order or agreement.

- To impose civil money penalties on any institution-affiliated party for taking any action that violates a law, order or regulatory directive and causes any harm to the bank.

In addition, the state regulator has the following authority over an industrial bank's parent and affiliates:

- To approve any restructuring or reorganization of the parent that affects control of the bank.
- To require the production of any information and directly examine the entity.
- To issue cease and desist and remedial action orders enforceable in state court against any party in control of the bank and to impose civil money penalties for any violation of such order.
- To take possession of the bank at any time effective upon posting notice of possession anywhere on the bank's premises.

This allows the state and FDIC to oversee every action or activity of the holding company and its affiliates that is or may be pertinent to maintaining the safety and soundness of the industrial bank, the deposit insurance system itself and the payments system

In some respects, FDIC and state oversight is more effective and efficient than the Federal Reserve's regulation of a traditional bank holding company. In the case of a traditional bank holding company, regulation is divided. The bank has one group of regulators and the holding company has a different regulator. If a bank regulator has a concern about something involving a holding company or affiliate subject to the Bank Holding Company Act, the regulator must generally work through the Federal Reserve to address that problem. I can tell you from personal experience that this is not always a smooth process and the lack of coordination can be frustrating at times.

This problem does not arise with an industrial bank because the same regulators simultaneously regulate the bank and holding company. This enables the regulators to see the whole picture and take coordinated action if needed to address problems that may occur at multiple levels. The bank's regulators must approve corporate reorganizations and securities sales if they affect the bank in any way. The only substantive difference between the regulation of a traditional holding company and an industrial bank holding company is that an industrial bank's regulators don't reach into areas of the holding company and affiliates that are irrelevant to the bank.

Holding Company Supervision by Securities and Exchange Commission

All of the securities firms that operate industrial banks are also supervised at the holding company level by the Securities and Exchange Commission (SEC) as "consolidated supervised entities." [4]

The SEC's "Consolidated Supervised Entity" regime (17 C.F. R. Parts 200 and 240) was established by the SEC under the authority of the Securities Exchange Act of 1934. While the SEC traditionally focuses on compliance with the investor protection provisions of the securities laws by a firm's broker-dealer and other affiliates, the consolidated supervised entity structure focuses on the capital adequacy and risk management practices of holding companies.

Eligible firms (very highly capitalized holding companies) provide information to the SEC with respect to firm-wide capital, as well as market, liquidity, operational and credit risk exposure, and systems for managing these risks. Specified financial and operational information is provided to the SEC on a monthly, quarterly and annual basis, and the firm must consent to

[4] SIA's membership also includes several traditional bank holding companies that operate industrial banks in addition to their commercial bank affiliates.

Commission examination of the holding company and material affiliates. SEC oversight involves both on-site examinations and ongoing communications with consolidated supervised entities. In recognition of their maintenance of mathematical models for measuring risks and group-wide systems for controlling these risks, consolidated supervised entities are permitted to use an alternative method for computing net capital, consistent with Basel II.

Consolidated supervised entity regulation was established, in part, to allow firms that do business in the European Union to comply with the requirement of the EU's "Financial Conglomerates Directive." That Directive states that firms doing business in the EU have a consolidated holding company supervisor equivalent to that applicable for their European counterparts. (A 2004 Guidance found that the SEC and Federal Reserve's holding company supervision satisfy this requirement). This is important because, while the "consolidated supervised entity" structure is a voluntary regime for U.S. firms, a firm that elected to withdraw from this supervision would become ineligible to operate in the European marketplace, a decision that is simply not an option for firms that derive very significant revenues from activities in Europe.

Government Accountability Office (GAO) Report on Industrial Loan Banks

The GAO's (GAO-05-621) report on industrial loan banks contains serious lapses and ingores important facts about the industry and should not be the basis for Congressional action. For example, the Report fails to discuss the SEC's oversight of holding companies that control the bulk of the industry's assets: the 99-page report mentions "consolidated supervised entities" just once, in a two sentence reference in the introductory segment to the report, which contains no further discussion or analysis. This lapse would be tantamount to reporting on U.S. military preparedness without discussing the capability of the Unites States Marine Corps.

The GAO report's comparison of the traditional bank holding company and industrial bank regulatory models concludes that the lack of oversight over unrelated activities is dangerous and warrants terminating the "bank centric" model. Based on my 23 years of experience in this area, I can make no sense of that conclusion. Unrelated activities are truly irrelevant to protecting the bank, and I can think of no reason to devote regulatory resources to areas that do not affect the bank.

Another point the GAO missed is the inherent weakness of the traditional bank holding company model. Traditional bank holding companies do little more than own banks. They are a legal structure overlaying the banks that are organized principally to manage the bank's stock and provide other services to the bank. A traditional bank holding company rarely has substantial assets apart from the banks it owns and makes little or no contribution to the bank itself.

I was a regulator during a time when significant changes in the financial services markets resulted in a lot of overcapacity and we had to close more depository institutions than at any time since the Great Depression. During the time I was with the Department of Financial Institution's we closed a third of the banks in the state. I can recall only a few instances when the holding company made any difference in the fate of its subsidiary bank. In almost every case, the holding company had no ability to rescue the failing bank and was nothing more than a bystander.

Because of this structural weakness, the Federal Reserve can only regulate holding companies to prevent them from causing a problem for their bank subsidiaries.

In contrast, diversified holding companies can make real contributions to their bank subsidiaries. Most diversified holding companies are many times larger than their industrial bank subsidiaries and could rescue their bank from any problem up to and including a total loss of the bank's loan portfolio. Nothing in the Federal Reserve's array of powers can protect against a bank's failure better than a capital maintenance agreement with a diversified parent many times larger than the bank itself.

In addition, many diversified holding companies contribute a fully developed business to their bank. Most industrial banks are organized to add value to an existing seasoned financial services business and begin as a large and profitable business with no marketing costs. A traditional bank could achieve that level of development only after several years of operations.

Despite their obvious importance, these strengths and weaknesses were not even mentioned in the GAO report.

The Role of the Financial Services Market

The final point I would like to make is that the development of industrial banks involves much more than competition between two regulatory models. The development is driven by changes in the financial services markets over the past 20 years, some of which resulted from changes in the law but more of it marketplace driven. New technology has made it much easier to offer financial products and services and that has resulted in a proliferation of both sources and kinds of credit throughout the economy. Businesses of every kind increasingly offer financial services. It may be the case that companies operating outside the traditional bank holding company structure provide most of the credit in the economy today. This expansion of credit has played a central role in the growth of the economy.

This is why I find it baffling that proponents of walling off traditional banks from competition continue to win supporters. Congress has already decided that restrictions against affiliations between banks and securities firms or insurance companies can be safely lifted, and banking-securities affiliations have operated without incident under both the bank holding company model and the industrial bank model. What sense does make to prevent other affiliations that can enhance credit availability without impairing the safety and of banks?

Until about 20 years ago, banks were the primary sources of credit and it was important to segregate them from other businesses so everyone had equal access to credit. Today, that is no longer necessary because there are so many diverse sources of credit. This has removed the risk of a credit concentration and replaced it with an array of legitimate companies providing high quality and high demand financial services. Many of those companies increasingly request access to a depository charter because it will enable them to operate their business more efficiently and cost effectively. Industrial banks have grown over the past 20 years primarily because they are an outlet for this growing market pressure.

There is simply no evidence that a company engaging in activities other than banking presents any safety and soundness risk to an affiliated bank. Financial services are a natural and logical choice for most businesses today. Many industrial banks offer financial services that they or their affiliates invented and are more proficient in providing than anyone else. For some companies, moving a financial services business into a bank is necessary to survive. For others, offering financial services is an opportunity to expand and deepen their customer relationships. This growing market trend cannot be legislated away and there is no good reason to oppose it. This conflict between the market and outdated provisions in the Bank Holding Company Act is the real issue underlying the controversy over industrial banks and banking commerce.

One thing I learned as a regulator is that the regulatory system serves the market and does not work well if the two are mismatched. This conflict between the market and the Bank Holding Company Act must be resolved before the current controversy will end. Repealing the exemption for industrial banks is not a solution. That would only cause the market pressures to grow until they find another outlet or finally induce Congress to repeal the Bank Holding Company Act limitations altogether.

How the different regulatory models fit with the markets is another glaring omission in the GAO report. In my view, that is its biggest flaw. No proper study of a regulatory structure could be made without reviewing in depth how it meshes with the industry it regulates and the markets it serves. The GAO study did not even mention the financial services industry or markets. It didn't assess why so many diversified companies want access to a depository charter or study market trends. Without that, the study was effectively blind.

Conclusion

I hope the information provided to the subcommittee today will clarify at least some of the misinformation and misunderstanding that has infected the debate about industrial banks during the past few years. The facts are simple:

- Industrial banks pose no unusual safety and soundness risk. The industry has developed into one of the strongest and safest group of banks that ever existed.
- The regulation of the industrial banks is comparable to, and in some respects stronger than, the regulation of all other banks.

- There is also extensive and effective regulation of the holding companies and affiliates. That regulation is performed by the SEC and concurrently by the banks' regulators and is more unified and coordinated than the divided regulation of traditional banks and their holding companies.
- Finally, there is nothing unusually risky about the market forces prompting the development of the industrial bank industry. Companies of every kind increasingly offer financial services, some because it is an opportunity to deepen and diversify existing customer relationships, others because of the necessity to meet customer demand and compete effectively. This development is natural and logical and has produced a broad array of companies engaged in many diverse and completely legitimate activities that want access to a depository charter because it enables them to provide their financial services more efficiently and cost effectively.

To be effective, the regulatory system must adapt to these changes. Allowing industrial banks to continue to serve the needs of the market is a proven and prudent way to accomplish that goal.