October 10, 2006

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Industrial Loan Companies and Industrial Banks
71 FR 49456 (August 23, 2006)

Dear Mr. Feldman:

America's Community Bankers (ACB)[1] is pleased to respond to the Federal Deposit Insurance Corporation's (FDIC) request for comments on the very critical issue of the significant supervisory concerns presented by elements of the modern industrial loan company industry. Your request for comments is timely. The recent applications for deposit insurance and change in control by two major retail chains seeking to acquire ILC charters raise serious concerns about conflicts of interests that would arise in the operation of an ILC by such a company, and competitive inequities that would occur if such firms were granted ILC charters.

The modern ILC industry also presents special challenges for the deposit insurance system. In the past, some ILCs rapidly grew deposits from outside the traditional banking sector, diluting the deposit insurance fund and weakening protections against losses from bank failures. Recent proposed business plans indicate that the additional regulatory actions may be necessary to avoid the damage imposed by such fast-growing ILCs.

Before answering the questions posed by the FDIC, ACB has some general observations. ACB believes that depository institutions of all types should have the ability to choose the charter that best suits the needs of their customers and business model. While ACB supports the existence and viability of the ILC charter as an option, we oppose any new affiliations between commercial firms and ILCs. We believe that ILCs must operate under commercial affiliation restrictions substantially similar to those Congress placed on unitary savings and loan holding companies by the Gramm-Leach-Bliley Act.[2] Additionally, while the FDIC has always been a diligent regulator of the ILC industry, significant gaps exist in its authority to supervise and

[1] America's Community Bankers is the national trade association committed to shaping the future of banking by being the innovative industry leader strengthening the competitive position of community banks. To learn more about ACB, visit *www.AmericasCommunityBankers.com*.

regulate ILC holding companies and other affiliates. Legislation addressing commercial ownership of ILCs and ILC holding company regulation is currently pending in Congress. The FDIC should not lift its moratorium on approving ILC applications by commercial firms until Congress has the chance to fully consider this legislation.

Questions and Comments

1. *Have developments in the ILC industry in recent years altered the relative risk profile of ILCs compared to other insured depository institutions? What specific effects have there been on the ILC industry, safety and soundness, risks to the Deposit Insurance Fund, and other insured depository institutions? What modifications, if any, to its supervisory programs or regulations should the FDIC consider in light of the evolution of the ILC industry?* [3]

New Commercial Acquisitions

The profile of new ILC entrants is clearly changing. More commercial firms have acquired ILC charters. Because these companies are not subject to comprehensive supervision at the holding company level, they create more potential risk than banks, savings associations and ILCs subject to holding company supervision by the Board of Governors of the Federal Reserve System (Federal Reserve) or the Office of Thrift Supervision (OTS). The potential entry of large retail companies into the banking system through the ILC charter would create even greater supervisory challenges for the FDIC and would increase risks in the banking system. As noted in an answer to another question, there is great risk of conflicts between a retail company's responsibility to operate the ILC in a safe-and-sound manner and its obligation to shareholders of the commercial parent to maximize the profits of the retail operation. Allowing a large retail company, such as Wal-Mart, to operate outside the statutory requirements that have been carefully crafted for other institutions is a risk in and of itself due to the extraordinary size of the company.

Not only does the current regulatory structure raise safety and soundness concerns, but because such firms are subject to a less rigorous level of regulation than bank and savings and loan holding companies, they are given a competitive advantage. Moreover, the trend in ILC applications is likely to lead to a full retail banking operation by Wal-Mart or other large retailers, which would have a dramatic negative impact on the viability of community banks. These competitive effects are explained more fully below under Question 4.

These concerns should be addressed in both legislation and the FDIC's regulation and procedures. We make specific recommendations in that regard below.

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[2] 12 U.S.C. § 1467(a).

[3] Our responses are intended to address all issues raised by the FDIC in its notice, although we do not answer each question posed by the FDIC. For ease of reading and to avoid repetition, we have combined our responses to many of the questions.

Dilution of the Deposit Insurance Fund

The rapid growth of deposits from outside the traditional banking sector into some ILCs at the beginning of the decade caused a serious dilution of the deposit insurance fund. The rapid growth not only weakened the FDIC fund, but also shifted the costs of protecting against losses from future bank failures to the rest of the banking system. Given Wal-Mart's penetration into the commercial retail markets, we believe that the proposed Wal-Mart Bank has great potential for rapid deposit growth. The FDIC must address the potential for rapid growth in deposits either as part of its rulemaking on deposit insurance assessments or separately – but it needs to be addressed. As ACB suggested in a recent comment letter to the FDIC, in order to compensate other depository institutions for material dilution of the deposit insurance funds, the FDIC should levy a "growth premium" on top of the regular premium assessments for large institutions that are growing deposits rapidly and materially diluting the reserve ratio.[4]

2. *Do the risks posed by ILCs to safety and soundness or to the Deposit Insurance Fund differ based upon whether the owner is a financial entity or a commercial entity? If so, how and why? Do the risks posed by ILCs to safety and soundness or to the Deposit Insurance Fund differ based on whether the owner is subject to some form of consolidated Federal supervision? If so, how and why? Should the FDIC apply its supervisory or regulatory authority differently based on whether the owner is a financial entity or a commercial entity? If so, how should the FDIC determine when an entity is "financial" and in what way should it apply its authority differently?*

The risk posed by ILCs to safety and soundness and to the Deposit Insurance Fund differs depending on whether the owner is a commercial entity. Risks arise from inherent conflicts of interest between the safe-and-sound operation of the ILC and the interests of the commercial parent to insure a profitable operation of the commercial enterprises of the holding company. Moreover, ILCs are not subject to important unitary thrift restrictions that would eliminate one critical type of conflict of interest. These conflicts are more difficult for the FDIC to manage or supervise because of the lack of consolidated supervisory authority over the parent company.

Conflicts of Interests

If an ILC is owned by a commercial entity, there is naturally a greater concern that credit decisions about loans to customers of the commercial parent or a commercial affiliate might be based on motives to sustain the sales of the parent or affiliate, rather than sound underwriting. Moreover, unlike grandfathered unitary thrifts[5], there is no statute prohibiting ILCs from lending to the commercial parent or other commercial affiliate. Loans to commercial affiliates directly link the success of the ILC to the success of the commercial enterprise.

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[4] Testimony of America's Community Bankers before the FDIC, April 10, 2006.
[5] 12 U.S.C. § 1468(a).

We noted in our testimony opposing Wal-Mart's application for deposit insurance special concerns related to the size of that particular enterprise and conflicts inherent in its business plan. As just one example, according to Wal-Mart's application, its bank would process billions of transactions as a credit card acquirer. The role of the acquirer (in this case Wal-Mart Bank) under current rules is to ensure that the merchant (in this case Wal-Mart stores) meets merchant qualification standards and is engaging in legitimate business. With the Wal-Mart Corporation on both sides of these transactions, there would be a conflict of interest that could place the consumer or taxpayer at risk. Further, there would be no effective barrier against financial problems in the commercial store spreading to the Wal-Mart Bank. In such a scenario, with hundreds of billions of dollars passing through the Wal-Mart Bank system, perhaps as high as 2 percent of the payments system overall, the risk of disruption stemming from financial problems at Wal-Mart would be great. The high number of transactions and the large dollar volume increases the importance of the need for the acquirer and merchant to be independent and free of influence from each other.

Consolidated Supervision

Some companies operating as a bank holing company or savings and loan holding company own ILCs. These holding companies are subject to consolidated supervision by the Federal Reserve and the Office of Thrift Supervision. ILCs owned by commercial firms that are ineligible to be savings and loan holding companies are only subject to the supervision of the FDIC.

While the FDIC is a diligent regulator, the agency was not established as a holding company regulator. The FDIC's supervisory authority over the parent and affiliates of an ILC is more limited than the authority of the consolidated supervisors over the holding companies and affiliates of banks and thrifts. The FDIC's authority to examine affiliates is limited to examinations necessary to fully disclose the relationship between the institution and any affiliate, and the effect of the relationship on the institution. Relationships would include contracts, transactions and joint operations. When there is no relationship, any reputational or other risk that could be discovered upon examination could be left undetected.[6] On the other hand, consolidated supervisors generally have the ability to examine the holding company or an affiliate whether or not there is a relationship.[7]

The FDIC has augmented its statutory authority over ILC parents and affiliates through agreements and conditions imposed when granting applications. But, according to the GAO, these authorities are limited to particular sets of circumstances and less extensive than those possessed by consolidated holding company supervisors.[8] The GAO has also commented that although the FDIC has successfully enhanced its supervisory approach to ILCs, the approach has not been tested during times of significant economic stress or by a large, troubled ILC.[9]

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[6] Report of the United States Government Accountability Office, *Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority,* page 6 (September 2005).
[7] *Ibid*, page 7.
[8] *Ibid*, page 7.
[9] *Ibid*, page 7.

The Federal Reserve requires bank holding companies to maintain specific levels of capital on a consolidated basis. The OTS requires a savings and loan holding company to maintain an adequate level of capital to support its risk profile.[10] Both bank holding companies and savings and loan holding companies serve as a source of strength for their depository institution subsidiaries. Under Federal Reserve and OTS policy, a holding company should stand ready to use its available resources to provide adequate funds to its subsidiary bank or association during periods of financial stress.[11]

On the other hand, the FDIC does not have direct authority to impose a capital requirement on the parent of an ILC. The FDIC can impose on the parent an obligation to maintain the capital of the ILC subsidiary through conditions imposed in an application process and enforcement actions against IAPs (including parent companies). However, this authority is less extensive than the consolidated supervisory authority of the Federal Reserve and the OTS.[12]

3. *Should the FDIC routinely place certain restrictions or requirements on all or certain categories of ILCs that would not necessarily be imposed on other institutions (for example, on the institution's growth, ability to establish branches and other offices, ability to implement changes in the business plan, or capital maintenance obligations)? In the interest of safety and soundness, should the FDIC consider limiting ownership of ILCs to financial companies?*

Conditions Applicable to All ILCs

ACB believes that all ILCs in a holding company structure should be subject to consolidated supervision at the holding company level. If an ILC is not part of a bank holding company supervised by the Federal Reserve or savings and loan holding company supervised by the OTS, then the FDIC should require as a condition of granting deposit insurance or approving an application for change in control that the parent of the ILC and all affiliates agree to be regulated and supervised in the same manner as bank and savings and loan holding companies. As part of this regime, an ILC's parent company should be required to enter into an explicit agreement to maintain the capital of the ILC at levels adequate to protect the safety and soundness of the ILC and the deposit insurance fund. We understand that the FDIC has required the parents of ILCs to enter into such capital maintenance agreements in the past. The practice should be routine and set out in regulations. Nevertheless, we believe it is important that Congress provide the FDIC supervisory authority over the parents of ILCs that is comparable to the authority of the Federal Reserve and OTS over holding companies.

[10] *Ibid*, page 31.
[11] See 12 C.F.R. § 225.4 and 12 C.F.R. Part 574.
[12] GAO Report, page 34. We note that the enactment of Section 702 of the Financial Services Regulatory Relief Act of 2006, the FDIC's ability to enforce capital maintenance agreements with the parents of ILCs and impose related orders have been considerably strengthened.

Restrictions on ILCs Owned by Commercial Firms

In 1999, in the Gramm-Leach-Bliley Act, Congress ended new commercial affiliations with savings associations and generally reinforced the policy of prohibiting commercial affiliations with banks. Given the concerns about the lack of consolidated supervision and the conflicts inherent in commercial ownership of ILCs, along with the federal policy expressed in Gramm-Leach-Bliley, ACB believes that the FDIC should prohibit new commercial affiliations with ILCs. Not only do the potential conflicts and lack of consolidated supervision compromise the safety and soundness of an ILC owned by a commercial firm, these factors create unjustifiable competitive inequities that could, over the long term, threaten the safety and soundness of other banks and savings associations.

Applications from large retail firms raise even greater safety and soundness concerns. As noted in our opposition to Wal-Mart's application, allowing Wal-Mart to operate outside the statutory requirements that have been carefully crafted for other institutions is a risk in and of itself due to the extraordinary size of the company.

However, to the extent that the FDIC permits such affiliations in the future, the FDIC should, in its conditions approving such affiliations, set strict limitations on ILCs owned by commercial firms. First, the FDIC should prohibit commercially owned ILCs from branching on an interstate basis. Second, the FDIC should set strict limits on the growth of commercially owned ILCs in order to control the competitive advantages that such institutions have over other banks and thrifts and in order to prevent a precipitous dilution of the deposit insurance fund. The FDIC should also act to minimize potential conflicts by, for example, prohibiting loans from ILCs to a commercial parent or affiliate. Moreover, the FDIC should place tight controls on the activities of such ILCs by requiring strict adherence to the business plan approved by the FDIC in connection with an application for deposit insurance or change in control. The FDIC should require such ILCs to seek permission to engage in any new activity, even if the activity is otherwise permitted by statute, and should only make such approvals after a notice and comment period.

4. *Do ILCs owned by commercial entities have a competitive advantage over other insured depository institutions?*

Commercially owned ILCs have a competitive advantage over other insured depository institutions. ILCs are subjected to a much less rigorous level of supervision and regulation at the holding company level. They are not subject to holding company capital requirements. The supervisory and regulatory authority of the FDIC over the parent and affiliates is not as comprehensive as the authority of the Federal Reserve and the OTS over banks and savings and loan holding companies. Different levels of regulation can create competitive disadvantages for those institutions subjected to more rigorous regulation.

The applications of large retail firms raise special competitive concerns for community banks. Even a limited initial grant of activity authority might inevitably lead to a Wal-Mart Bank that

offered a full range of retail banking services. Given the size and competitive strength of the Wal-Mart operation, a full-service Wal-Mart Bank would threaten the viability of community banks throughout the nation. Moreover, such an operation would eventually displace the retail operations of some 1,300 banks currently in Wal-Mart stores, further deteriorating the competitive position of these banks in their communities.

5. *What statutory or regulatory additions should be made to enhance the FDIC's oversight of ILCs?*

ACB strongly supports H.R. 5746, the Industrial Bank Holding Company Act of 2006, which would provide consolidated supervisory regulation of ILC holding companies similar to that which is applicable to bank and savings and loan holding companies. Moreover, it would provide restrictions on commercial ownership of ILCs, which are generally based on provisions in the Gramm-Leach-Bliley Act limiting commercial ownership of unitary savings associations and commercial activities of newly formed financial holding companies.[13]

H.R. 5746 would require that each parent company of an ILC be subject to consolidated supervision as an "ILC holding company" by the FDIC, unless subject to consolidated supervision by the Federal Reserve or OTS. The legislation would give the FDIC regulatory and supervisory authority similar to the authority of the Federal Reserve and OTS as holding company supervisors. The legislation would prohibit commercial firms (firms with 15% or more of consolidated income from non-financial activities) from acquiring ILCs. It would allow a commercial firm that acquired an ILC before October 1, 2003, to maintain ownership of its ILC with no additional restrictions on the activities of the ILC. A commercial firm acquiring an ILC from October 1, 2003 through June 1, 2006 could maintain ownership of its ILC, but the ILC would not be permitted to engage in any new activities and could not branch into another state. ACB suggests that the FDIC consider borrowing the legislation's definition of "commercial" entity in adopting regulations and policies related to commercial ownership of ILCs.

ACB believes that the risks associated with the new commercial acquisition of ILCs are too great to permit until the regulatory regime for ILCs is significantly strengthened. We respectfully request that the FDIC continue its moratorium on the approval of such applications until Congress has provided a stronger regulatory structure for ILCs. However, should the FDIC decide that the moratorium should end, we respectfully request that the FDIC continue its moratorium until it can adopt our suggestions for strengthening its oversight of ILCs through notice and comment rulemaking.

[13] *Op. cit.*, section 401

Conclusion

Thank you for the opportunity to comment on this important matter. Should you have any questions, please contact Ike Jones at 202-857-3132 or ijones@acbankers.org.

Sincerely,

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Regulatory Affairs