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THE ILC DEBATE: REGULATORY AND SUPERVISORY ISSUES

REMARKS BEFORE THE
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Good morning. It is great to be here today with so many friends - friends of mine, and friends of the FDIC. I appreciate the great work you do in your states, in your banks and in your communities every day - under challenging circumstances, tight budgets, and a difficult economy - to protect the safety and soundness of the country's banking system. We value our relationship with you and appreciate the coordination and open communication that we share as we fulfill our respective duties.

I struggled a bit about what to discuss today. There are many issues in Washington that call out for attention - some are very important, others less so. But there is an emerging topic in the banking policy arena that directly impacts many of you in this room - bankers and bank supervisors - as well as the FDIC. And that is the matter of how our regulatory system should address the mixing of banking and commerce.

This issue has come to the fore recently with the debate in Congress about whether Industrial Loan Companies should be considered equal with other banks when it comes to powers like interstate branching and paying interest on business checking.

These ILC-powers issues have raised great concern among bankers. They have also attracted the attention of those who believe the bank holding company structure is the only sound model for regulation in situations where insured banks operate within larger organizations. Both concerns relate to the underlying anxiety over the broader question of the extent to which commercial firms should be allowed - in any fashion - to affiliate with banks.

This issue has all the trappings of a good old-fashioned Washington dustup: We've got market forces at work, innovations appearing - you can almost hear the wagons circling.

We've seen this before. The evolution of banking law has typically come from the outside in - sometimes through market pressures, or often through a crisis, building the momentum needed to force reforms on otherwise reluctant policymakers and, sometimes, even the market participants themselves. There's nothing wrong with this -

and in my view these changes should come from the broader marketplace rather than from inside the beltway.

It's fair to say that this process of change is somewhat disruptive, but nonetheless fairly efficient. Someone builds a better mousetrap and the world - eventually - beats a path to his door.

But banks - as we all know - are unique. They operate in a highly regulated environment. Banks also carry the deposit insurance guarantee, they play a vital intermediary role, and they must maintain public trust in their operations. Change in the banking arena is more difficult than in the broader marketplace because you must first satisfy a number of third parties. The regulators, the Congress, the public, and the other players in the political marketplace must all be heard from before evolution can take its course.

This is not altogether a bad thing. Banking is regulated for good reason. The crises, market pressures, and political dynamics of the past have left us with our current structure. Now, some of us would certainly prefer less structure - but that is a different topic for a different day. The purpose of our regulatory system is to make sure the public retains its confidence in insured banks and thrifts. We must work to ensure imbalances do not build to the point where the entire system becomes destabilized and threatens our prosperity and our way of life. That is the goal of regulation - and we all have an interest in achieving it.

But we must be watchful, as well, against the possibility that the regulatory system itself does not impair the vital process of innovation and change that is the lifeblood of the American marketplace. There is a natural tension here. At the FDIC, we're taking a hard look at this question in our Future of Banking study. But I'd like to lay out some of our preliminary thinking here today.

First, let me start with the disclaimer that I love the free market. I believe greatly in the power of the marketplace to innovate, to bring beneficial change, to improve our way of life and our way of doing business.

Our continuing challenge as regulators is to make sure that these market innovations can take place while protecting financial consumers from the risk of instability. And I admit, this is not always easy. There is a continuing tension between the customer's interest in products that are better and cheaper, and the regulator's interest in making sure these new business practices do not endanger our financial system. This is the philosophy I bring to most issues we face at the FDIC: How can we allow market innovations while performing our legitimate regulatory function in the most efficient and effective manner?

These tensions are rising again around the specific issue of whether industrial loan companies, or ILCs, should be allowed the same branching and payment of interest on business checking rights that other banks enjoy. When we consider important decisions

like this, those of us in the policymaking arena must base our analysis on a dispassionate reading of the facts, the history, and future implications.

So, let's look at the facts. First, it is important to state that these entities are nothing new. They've been with us for nearly a hundred years. They engage in a variety of businesses, but they can generally be grouped into several broad categories.

Some ILCs, for example, are community-focused institutions - either stand-alone or part of a larger organization - that provide credit to consumers as well as small- and medium-sized enterprises. Others focus on specialty lending programs, like leasing and real estate activities, funded by retail and wholesale deposits, borrowings and capital. A third model is made up of institutions that are affiliated with organizations that serve a particular purpose within the larger financial organization - like providing FDIC-insured products, performing cash-management functions, or administering escrowed funds.

A final broad category is made up of ILCs that directly support the parent organization's commercial activities - like financing a particular enterprise's automobile fleet, consumer electronics purchases, heating and air conditioning installations, and so on.

A few more facts: ILCs do not represent a significant portion of the banking business in America. Just over 50 ILCs have deposit insurance. Most of these are in California and Utah. At year-end 2002, they held just over $120 billion in assets. This represents only 1.4 percent of the total assets held in all insured institutions.

As I've already mentioned, ILCs today exist at the intersection of many developments in the financial system and raise a number of legitimate issues. However, I believe that some opponents of ILCs may be blurring the facts in order to make their case. For example, some ILC opponents have raised the issue of the complexity of ILCs and the ability of the FDIC and the states to adequately supervise them. We deal with complexity every day. It is our job. At the FDIC, we have a 70-year history of prudent supervision, and we have provided stability to the financial services industry during some of the most significant economic crises this country has ever faced.

I am very proud of our record supervising ILCs and the other 5,000 state-nonmember institutions we regulate.

Let me be very clear: The ILC banks are subject to the exact same regulatory oversight and laws as the other 5,000-plus banks and thrifts for which the FDIC is the primary supervisor. They must comply with the same capital standards as other institutions. We can and do demand additional capital when needed. ILCs must follow the same rules on consumer compliance and community reinvestment. They are subject to the entire gamut of the FDIC's Rules and Regulations and enforcement authority. And they are also subject to Sections 23A and 23B of the Federal Reserve Act, which govern transactions with affiliates, as well as Regulation O, which governs credits to insiders and their related interests. All this makes the point that these organizations are

rigorously and sufficiently supervised by the state supervisors and by the FDIC on an ongoing basis.

Now, there have been questions about the oversight of their parent companies - many of which are commercial firms. While I understand these concerns, the FDIC has - and often uses - a number of tools to manage both the holding company's involvement with the financial institution, and to manage transactions between the two entities.

We can and do visit the parent companies - and other affiliated entities, for that matter - to look over issues or operations that could impact the insured institution. Congress has given us the power to protect the integrity of those relationships. We have exercised that power, and we have coordinated closely with you - the state regulators - in our work. We have found parent companies of ILCs to be acutely conscious of their responsibilities with respect to their ILC subsidiaries and the consequences of violating applicable laws and regulations.

It is important to note here that risk posed by any depository institution depends on the appropriateness of the institution's business plan and model, management's competency to run the bank, the quality of the institution's risk-management processes, and, of course, the institution's level of capital.

We at the FDIC must all be vigilant in our supervisory role. But I will reiterate: The FDIC believes the ILC charter, per se, poses no greater safety and soundness risk than other charter types.

Further, the firewalls and systems of governance safeguarding ILCs from misuse by their parent companies are, in many cases, more stringent than what exists in many affiliates of bank holding companies. In part, the generally positive experience of the ILC charter in recent years is attributable to a continually evolving supervisory approach that considers each institution's purpose and placement within the organizational structure.

In addition to our ongoing supervisory activities - conducted in both the bank and the parent - we also impose significant restrictions on new ILCs before they receive deposit insurance. Depending on the purpose and placement of the bank within the organizational structure, mandated safeguards include: on-site management rather than management from distant corporate headquarters, independent boards of directors, strict guidelines to ensure arms-length transactions with the parent and other affiliates, and so on.

So, if the issue is not safety and soundness, what is the issue? There are two. One concerns the proper relationship between banking and commerce. The other is competition.

Many worry about competition in the future that may come from new entrants into the ILC environment. I understand these fears. After all, I was a community banker once and I know all too well the pressures these institutions feel every day.

But before going too far down that road, it is important to study the history of the banking industry and its ability to handle competitive challenges. It is truly an exemplary record of achievement.

The industry remained competitive through the consumer protection reforms of the 1970's, the disruptions of deregulation, the crisis of the late 1980's and early 90's, the interstate branching reforms, and the rise of nationwide financial conglomerates. These developments - at the time - were of great concern to many of us in the industry. In fact, I was part of the leadership of a group in Texas that opposed county branching.

Yet, the industry survived - and survived in record shape. Financial institutions earned more money last year than at any time in their history. Don't get me wrong. Bankers who are concerned about competition from ILCs or anywhere else have a valid concern and that is a discussion we should have. The FDIC is working to provide facts and analysis for a debate on ILCs and other competitive forces facing a changing banking industry. In our Future of Banking study, we're taking a hard look at the best and proper role for affiliations between commercial firms and banking entities in this country - and we are analyzing the appetite of the marketplace for these types of arrangements.

These are important questions for all of us to consider as we continue this debate in which you as state supervisors can play a vital role. I hope you come forward and share your views with us as the study continues throughout the year.

I've been in Washington long enough to know better than to leave any room for doubt as to the way I feel about something, especially something as important as this issue.

So that there will not be any misunderstanding or misconstruing of what I have said here today, please indulge me just a moment as I summarize the five points I've made today:

One, we at the FDIC have not staked out a position on the spectrum of banking and commerce as to where the industry ought to be - but we will once we hold our symposium on banking and commerce this summer and complete our Future of Banking study. We believe that it's important to encourage and participate in robust debate on important policy issues such as this one.

Two, having said that, the question is not, "Should we allow the mixing of banking and commerce?" - because it already exists - but rather, "To what extent should it be allowed, and under what conditions?"

Three, I acknowledge the tension between free market forces and the customer's interest in better and less expensive products, and our responsibility as regulators to

ensure that these market pressures do not jeopardize the stability of our financial system on the other hand.

Four, while I understand the anxiety some people have on this issue, fear of competition should not be the compelling argument in formulating good public policy.

Five, and finally, we at the FDIC have not identified any safety and soundness concerns unique to ILCs, and are certain that we have the tools and the ability necessary to sufficiently supervise them.
Thank you again for all the good work you do on behalf of the state chartered banking system. Again, we appreciate and value the relationship we share on the supervisory front and look forward to many good days ahead.

Thank you.

Congress created the Federal Deposit Insurance Corporation in 1933 to restore public confidence in the nation's banking system. The FDIC insures deposits at the nation's 9,354 banks and savings associations and it promotes the safety and soundness of these institutions by identifying, monitoring and addressing risks to which they are exposed. The FDIC receives no federal tax dollars - insured financial institutions fund its operations.

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