Good morning. As always, I’m delighted to attend the Utah Association of Financial Services Convention. Thank you for extending an invitation.

As we meet this morning, in this serene mountain setting, I am impressed with the changes wrought in the Utah Industrial Bank industry over the last 16 years, maybe some foresaw the potential of this industry, I did not. While Utah Industrial Banks have established a record of safe and sound operations, there are detractors. As we meet here today, there are people in Washington D.C. who oppose what you are doing and how you are doing it. There are those who want Industrial Bank activities, more specifically, those with commercial parent companies severely restricted if not completely reversed. For those of you in the room and your parent companies, my charge to you this day is: if you want to prosper and succeed in your banking operations, you must first as I previously have stated, “Do It Right” and secondly join the effort to convince Congress that this industry does not represent a threat to the banking system.

Over the years I have stated my view that there are two threats to the Industrial Bank industry, first, Regulatory, the second, Congressional. In theory, if you completely address the first two then a third threat could materialize, that is Complacency, but as long as you are wholly engaged in the first two efforts then I do not anticipate the third arising.

Since your last annual meeting, I have delivered speeches, participated in panel discussions and answered questions on Industrial Banks before such diverse groups as America’s Community Bankers (ACB), Conference of State Bank Supervisors (CSBS), State Banking Symposium, American Bankers Association (ABA), Washington D.C.’s Women in Housing and Finance, General Accountability Office (GAO), the National Conference of State Legislatures (NCSL), FDIC’s IB Symposium, FDIC’s Inspector General, Utah Legislative Committees and Utah’s Congressional Delegation.

I have and will continue to defend (in partnership with the FDIC) our regulation and supervision of your industry. We take our supervisory role seriously. We believe we are an active participant with the FDIC in all Industrial Bank examinations and targeted reviews where ever they are conducted. To the groups mentioned above, I have tried to articulate the foundations of our brand of supervision and the prudential steps we have taken to properly regulate and supervise your activities.

THE NUMBERS

I have passed out a list of the IBs as of today with the total assets as of last quarter end, June 30, 2004.

The list also includes applications approved and pending.

DO INDUSTRIAL BANKS POSE A THREAT TO THE BANKING SYSTEM?

I say No! FDIC Chairman Powell says not any more than any other charter type.

However, some observers focus in on your perceived lack of parent company supervision by the Federal Reserve as evidence that Industrial Banks pose a threat to the banking system.
If you have not read the article on FDIC’s Supervision of IBs in the first edition of that agency’s new publication, *Supervisory Insights* for Summer of 2004, I recommend you do so. Quoting from portions of that article:

“ILCs are FDIC-supervised financial institutions whose distinct features include the fact that they can be owned by commercial firms that are not regulated by a federal banking agency. Some observers question whether current arrangements for overseeing the relationship between an ILC and its parent would provide sufficient safeguards if more extensive mixing of banking and commerce were permitted. This article describes the FDIC’s approach to supervising ILCs and its historical experience with the ILC charter. Because Utah is home to by far the majority of the commercially owned ILCs, we highlight the supervisory practices Utah and the FDIC have employed with respect to the ILC-parent relationship.”

The article then goes on to discuss how supervisors protect FDIC-insured entities that are part of larger organizations. Count myself among those who worry if we as regulators are doing enough in this area. After thinking on this for some time, I have concluded that time will be the judge if sufficient safeguards are in place. The article goes on to state:

“Strategies to monitor and control a bank's relationship with affiliated and controlling entities are fundamental to effective bank supervision under any organizational form that banks adopt. This principle is enshrined in U.S. banking legislation, bank regulation, and supervisory practice. Stand-alone banks, savings associations, bank and thrift holding company subsidiaries, industrial loan companies, and other FDIC-insured entities are subject to Sections 23A and 23B of the Federal Reserve Act, which limits bank transactions with affiliates, including the parent company. Federal Reserve Regulation O places limitations on loans to bank insiders and applies to all insured banks. The Prompt Corrective Action regulations required under the Federal Deposit Insurance Act (FDI Act) mandate progressively severe sanctions against any insured bank whose owners fail to maintain adequate capitalization in that bank.

As with any bank-level review of an institution with affiliates, examination procedures include an assessment of the bank's corporate structure and how the bank interacts with the affiliates (including a review of intercompany transactions and interdependencies) as well as an evaluation of any financial risks that may be inherent in the relationship. Examiners review the current written business plan and evaluate any changes. Examiners also review any arrangements involving shared management or employees.

All services provided to or purchased from an affiliate must be on the same terms and conditions as would be applied to nonaffiliated entities. All service relationships must be governed by a written agreement, and the bank should have a contingency plan for all critical business functions performed by affiliated companies.”

Besides all normal jurisdiction and enforcement authorities over IBs, pursuant to Section 7-8-16 of the Utah Code, each IB 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 IB holding company is subject to examination and enforcement authority of the department.

The FDIC authority over any affiliate including the parent company is made clear in another part of the article.

“In examining any insured depository institution, the FDIC has the authority (under Section 10(b) of the FDI Act) to examine any affiliate of the institution, including the parent company, for purposes of determining (i) the relationship between the ILC and its parent and (ii) the effect of such a relationship on the ILC. Further, Section 10(c) of the FDI Act empowers the FDIC, in the course of its supervisory activities, to issue subpoenas and to take and preserve testimony under oath, so long as the documentation or information sought relates to the affairs or ownership of the insured institution.
Accordingly, individuals, corporations, partnerships, or other entities that in any way affect the institution's affairs or ownership may be subpoenaed and required to produce documents. In addition, the states of Utah, California, and Nevada have direct authority to conduct examinations of parents and affiliates.

Monitoring and controlling the relationship between an insured entity and its parent company is an important part of the banking agencies' approach to supervision. This is true under any organizational form banks adopt, including the limited number of banks now operating as subsidiaries of a commercial firm or other nonbank entity. Because Utah is home to a number of commercially owned ILCs, the evolving supervisory strategies developed by that state and the FDIC provide a window into the processes and procedures that are important to consider in any discussion of insulating an insured entity from potential abuses and conflicts of interest by a nonfederally supervised parent. Cooperation between regulators from the state authorities and the FDIC's San Francisco Region and ILC management has resulted in critical controls, including requirements for local management, boards of directors, and files, as well as definitive business plans for the ILCs. More broadly, experience with the ILC charter reinforces the conclusion derived from other charter types that effective bank-level supervision is a key ingredient in safeguarding insured institutions from risks posed by parent companies.

Another publication, *Bank Director*, in its second quarter 2004 issue reprinted a live dialog before one of their recent conferences between former FDIC and RTC Chairman L. William Seidman and former ICBA President Kenneth Guenther. Eventually their conversation was directed to the ILC issue I would like to quote from part of their exchange:

“Guenther: The ILC is a hybrid charter. It’s found in six states, most heavily in Utah. Because it is hybrid charter, it is not controlled by the Federal Reserve Board under the Bank Holding Company Act. The Wal-Mart threat is not an empty threat. Wal-Mart did try to buy an ILC in California, the application was put in, the superintendent of banks had approved it, and the chairman of the FDIC – perhaps looking for increased regulatory power – indicated that he saw no safety and soundness problems with ILC’s. In his recent article in Bank Director, Bill points out that when he was the FDIC chairman, there no safety and soundness problems with ILC’s. Since that time, though, two ILCs have failed in California and have, therefore, put some pressure on the insurance fund.

In essence, there are really two issues. One, Wal-Mart can buy an ILC. Two, it’s a ‘regulatory light’ structure; those that don’t want to be under Federal Reserve rules and regulations can use the ILC loophole. Fed Chairman Alan Greenspan argues very persuasively that this weakens the regulatory structure. So the bigger players like Merrill Lynch and others that do not want to be under the Federal Reserve System can buy an ILC and get into banking that way... I think there is a safety and soundness problem, I think there are regulatory turf problems, and I think this is a charter that should remain constrained.

Seidman: Let me just say that the only problem I have had with Ken over the years is that he worked for the Fed for long, long time, and while you can take the boy out of the Fed, you can’t take the Fed out of the boy. Ken was a great representative for the small banks, he also has an inherent Federal Reserve point of view, which essentially holds that the Fed ought to be the regulator of all banks, that we ought to have a central regulatory system, and that we ought to separate commerce from banking. I used to think the separation of commerce and banking was simply a Federal Reserve argument for broadening its power and allowing it to be superregulator. However, I have spent a lot of time in the 10 years in the Far East, and when banking and commerce get together in the wrong way, huge problems can emerge.
To get back to the ILC’s, ... They are not consumer banks, They do have other banking powers, though, and it can be argued that a lot consumers would probably like to have a bank in Wal-Mart or other similar places. These exist now; they are simply not run by Wal-Mart. In this day and age, it seems pretty hard to argue that you have to prevent Wal-Mart from owning a bank because you are afraid it will serve the consumer better and run traditional banks out of business. First, I don’t think that will happen; second, they are not the same kind of banks. In the end, I think the argument that it is better to protect business rather than allowing it to compete freely is likely to lose politically, So the issue to me becomes how will ILCs create an unfair advantage in Banking?

Guenther: Let’s drill down a little bit. Take an ILC bank chartered in Utah. Is an ILC bank in Utah adequately supervised? FDIC Chairman Don Powell would say, ‘Yes.’ The superintendent of banks in the state of Utah would say, ‘Yes.’ I accept that, but then take an ILC bank owned by Merrill Lynch. What happens to the regulation at the holding company level? Now pit this against New York State Attorney General Eliot Spitzer’s near-criminal indictment of Merrill Lynch, and it raises the specter of failure, just as it did with Arthur Anderson. So you have the superintendent of banks in Utah saying there’s no safety and solvency problem at the bank level, Don Powell saying there’s no safety and solvency problem at the bank level, but then when you have a bank owned by Merrill Lynch you potentially have a major safety and solvency problem at the holding company level.

Yes. I do come out of the Federal Reserve System and I do think umbrella supervision and regulation are necessary. I think if you took that away, it would increase systemic risk. In the case of ILCs right now, if they gain approval we will be allowing the rise of a parallel, less-regulated system.

Seidman: Ken’s essential argument is that you have to regulate anybody that owns a bank. I know of many more banks that have been wrecked by doctors than by corporations! So it is hard to say that Wal-Mart has an increased potential of going bust, which would in turn hurt the banking system. In the first place, the FDIC regulates ILCs the same way it regulated community banks – with respect to owners and what they can do. So there is really nothing new about the idea of regulating the owners of banks."

In this discussion and others the worst case scenario is a holding company filing bankruptcy or getting into financial difficulty. Utah has experienced both in the last 18 months. We have had large corporate parents of IBs encountering financial difficulties, in one instance the ultimate parent company filed for bankruptcy protection. In the bankruptcy proceeding, the insured IB within the corporate family entered into an asset purchase and assumption of liability Agreement with another depository institution. A $300 million premium was returned to the parent in that Agreement for the IB.

In another case the large parent company encountered financial difficulties and decided to spin the IB group off in an initial public offering which was approved and completed. The IB continues operations today.

I have over time made the case that what we engage in is, “Bottom-up supervision” of the IB’s parent company. This is not a new concept when examining a bank that is part of a holding company structure. However, IBs based
in Utah have represented a, “laboratory” for regulators 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.

DO INDUSTRIAL BANKS REPRESENT AN INAPPROPRIATE MIXING OF BANKING AND COMMERCE?

No! Some observers argue that they are already mixed. The Gramm Leach Bliley Act in 1999 endorsed insurance and securities firms as being “financial in nature” to merge with banking but drew a distinction with “commercial” firms and said that was not okay.

As we all know business combinations between banks and commercial firms exist today.

In its simplest terms, I believe, one can think of mixing banking and commerce as: banks are sources of funds and all other enterprises including commercial firms are users of funds. Those entities that supply funds should not be connected to those entities that use the funds. Some believed that the root cause of the Great Depression of the 1930s' was the mixing of banking and commerce. Therefore the desirability of keeping banking and commerce separate exists today, even though in the rest of the world the mixing is very prevalent.

There are “three horribles" originally put forth in Congressional testimony by the former Federal Reserve Chairman Paul Volcker. Mr. Volker described the evils that will occur when the suppliers of credit- i.e., banks- control or are controlled by the users of credit- i.e., everyone else.

They are:

- The bank with a commercial affiliate will lend preferentially to the affiliate, whether willingly or under duress from a commercial parent.
- The bank with a commercial affiliate will not lend to competitors of its commercial affiliate.
- If the bank's commercial affiliates get into financial difficulty, the bank's resources will be marshaled to bail them out, whatever the law says."

After Congress passed the Gramm-Leach-Bliley Act of 1999, where essentially they endorsed mixing banking and commerce, it is permissible for banks to be affiliated with securities firms and insurance companies - on the theory that all are involved in what is loosely called "financial activities" and not in what might be called "commerce."

CURRENT CONGRESSIONAL LEGISLATION

The IB issue has been raised as part of the Congressional debate on two banking related bills. My view is that the IBs did not go to Congress and ask for these enhanced banking powers, my understanding is that the banking associations and the federal regulators asked for them. In my view, all the ILCs are saying is, do not discriminate against them. If Congress is considering giving these new powers to all other financial institutions, let's have parity.
The first bill H.R. 758 Business Checking Freedom Act among other provisions gives banks, including IBs, the authority to pay interest on business checking accounts. Despite opposition that IBs should not be included, this bill passed the House and is awaiting action in the Senate.

The second bill H.R. 1375, Financial Services Regulatory Relief Act approved by the House on March 18, 2004 would repeal all state restrictions on the establishment of interstate bank branches, allowing any bank - including IBs - to establish a de novo out-of-state branch. Like other banks, IBs already have the authority to establish interstate branches through acquisition.

The Federal Reserve Board, and three members of the House Financial Services Committee, expressed objection to allowing IBs controlled by “commercial” firms to take advantage of this authority. The bill approved by the House contains a manager’s amendment which among other provisions limits IBs controlled by commercial firms from taking advantage of the new de novo branching authority.

The House bill provides that an IB chartered or acquired after October 1, 2003 by a “commercial” entity (a firm that derives more than 15% of its revenues from activities that are not “financial in nature or incidental to financial activities”) may not use de novo branching authority. IB’s current authority to establish branches through acquisition was not changed, and the bill does not affect the ability of IBs chartered before October 2003 to use the new de novo branching authority. The Senate has not taken action on this legislation.

While some observers have argued that this is a workable compromise, it still constitutes a roll-back of powers that IBs enjoy today; as IB’s, at least those chartered in Utah, are authorized to branch into 17 other “reciprocity” states. There is also within the compromise that branches must be closed no matter how long they have been opened if the bank is purchased by a “commercial” entity.

BANKING AT WAL-MART?

In my view, all of this “merging banking and commerce” debate would have remained an esoteric discussion for the Federal Reserve, a select group of regulators and Congress had it not been for a specific case that caught the attention of the ICBA, the national association of independent community bankers and as I have previously read, that case is the world largest retailer “Wal-Mart.”

Wal-Mart in its second attempt to get into banking made an offer to purchase a small ILC in California to facilitate credit card clearings on their own without having to pay a bank to do it for them. Once the California community bankers and labor unions became aware of this effort they united in opposition to stop the acquisition. They were instrumental in having the California Legislature pass legislation that prohibited a “commercial” company from acquiring a California ILC.

First, for the record! Wal-Mart does not have a Utah IB charter and has not applied for a Utah IB charter!

If some are concerned about a retailer using an ILC charter to branch interstate, the answer is yes they may, and as previously mentioned, since Utah is a reciprocity state, ILCs currently may branch into 17 states. That is the correct answer but reality is accomplishing that would require multiple regulatory approvals and with only four branches operating for all Utah ILCs, I would submit that is not a pattern of operation evident today.

Wal-Mart could have applied for an ILC charter in Utah for the last 17 years and has not done so. If Wal-Mart wanted to establish branches in those 17 states, it could have done so for the last four years but again has not.

If Wal-Mart ever chooses to apply for an ILC charter in Utah it would go through the same regulatory process and its business plans would be analyzed and reviewed based upon the same criteria as all other applicants.
Much attention has focused on the possibility that Wal-Mart or another large retailer might obtain an ILC charter and open branches throughout the country. Although Wal-Mart has stated it has millions of customers who have no relationships with banks and millions more who are underserved by local institutions, it has also stated that it is no longer pursuing a bank acquisition to serve the needs of these individuals. The company’s application for an ILC charter in California was abandoned in 2000. Wal-Mart has not subsequently filed an application elsewhere, and apparently is focusing instead on a strategy of offer banking services to Wal-Mart customers through partnerships with unaffiliated banks.

For more than two decades beginning in the 1970’s, retailers (including the then-largest retail companies, Sears, JCPenney and Montgomery Ward) entered and left the banking industry. These companies chartered or acquired credit card banks, so-called “nonbank banks” and ILCs, and used these institutions principally to provide credit cards to consumers. Despite concerns about the impact of these acquisitions on competing institutions, or the dangers of commercial ownership of banks, none of these relationships resulted in harm to consumers, competitors, or the deposit insurance system. None of the banks controlled by these retailers was used to establish a network of bank branches. In most instances, the retailers, like Wal-Mart, subsequently elected to provide banking services through arrangements with unaffiliated financial institutions, rather than through company-owned banks.

Finally I wanted to make a pitch asking for your support of the third CSBS sponsored Directors Seminar and Training to be held Thursday and Friday, October 7 & 8, 2004, at the Couer d’Alene Resort in Couer d’Alene, Idaho. This is training designed for your directors, to which I believe you also will benefit. It has been held the last two years. You have received an initial invitation from me and can access the CSBS web page for registration information.

Thank you.