National Bank Charters and Federal Savings Bank Charters Are Preferable in Important Respects to Industrial Loan Company Charters

Likely restrictions on the availability of industrial loan company and industrial bank (collectively “ILC”) charters and increased regulation of ILCs have been the subject of significant legislative and regulatory activity and related press coverage over the past two years. However, the potentially greater benefits for many businesses of national bank charters and federal savings bank charters compared to ILC charters have received much less press attention during this same period.

This client alert briefly summarizes recent developments with respect to potential ILC limitations and provides a summary overview of the major advantages of the federal savings bank charter and the national bank charter compared to ILC charters.

This client alert could be very useful for certain investment management and mortgage banking clients and friends of our firm since companies engaged in these activities frequently are interested in expanding into the depository institutions business and they generally are permitted under applicable legislative and regulatory provisions to acquire control of federal savings banks or national banks.

ILCs had become the last available vehicle for companies engaged in commercial activities to acquire or form state-chartered banks offering FDIC insured deposits and for the companies controlling these depository institutions to avoid strict federal regulation as bank holding companies. However, Congress now is actively developing legislation to restrict the ability of entities engaged in commercial activities to control ILCs and to increase the regulation of ILCs. And the Federal Deposit Insurance Corporation (“FDIC”) recently has proposed significant ILC regulations and has extended its moratorium on acting on insurance of accounts applications and change of control notices relating to ILCs controlled by commercial companies.

Legislation may very well be enacted before the end of the current 110th Congress precluding companies engaged in extensive commercial activities from prospectively acquiring or forming ILCs. Entities engaged primarily in activities that are financial in nature, and engaged only to a limited extent in commercial activities, probably will be able to continue to form and own ILCs -- although the holding companies of these new ILCs probably would be subject to greater regulation and supervision than ILC holding companies have been subject to in the past. But for the reasons summarized in this alert, many companies engaged in activities that are financial in nature, such as mortgage banking or investment management activities, that desire to own a depository institution, should seriously consider obtaining a federal savings bank charter or a national bank charter rather than becoming an ILC holding company.

1 The terms “industrial loan company” and “industrial bank” mean any FDIC insured, state-chartered bank that is an industrial bank, industrial loan company or similar institution and that is excluded from the definition of “bank” in the Bank Holding Company Act pursuant to 12 U.S.C. § 1841(c)(2)(H).

2 A company that controls an ILC can avoid classification as a bank holding company provided that the ILC either: (i) does not accept demand deposits that depositors may withdraw by check or similar means; or (ii) does not have total assets of $100,000,000 or more. 12 U.S.C. § 1841(c)(2)(H). However, an ILC will not be a bank under the Bank Holding Company Act if it offers NOW accounts, which require seven days notice of withdrawal.
I. Background and Recent ILC Developments

As is widely known, the current ILC legislative and regulatory developments were generated primarily as a result of applications filed by Wal-Mart Stores, Inc. (“Wal-Mart”) in July 2005 to form an ILC under Utah law and obtain deposit insurance for the ILC from the FDIC. The Wal-Mart applications were strongly opposed by depository institution trade associations, including the American Bankers Association, the Independent Community Bankers of America and America’s Community Bankers. The Wal-Mart applications also were opposed by many members of Congress and by the Board of Governors of the Federal Reserve System, which has believed that banking and commercial business should not be controlled by the same company. Primarily in response to this opposition and criticism, on March 16, 2007, Wal-Mart withdrew its applications to obtain an ILC charter and related deposit insurance.

The Home Depot, Inc. also applied to acquire control of an ILC, EnerBank USA, which is located in Salt Lake City, Utah. The Home Depot applications, which are still pending, also generated substantial opposition from banking groups, members of Congress and other organizations.

On May 21, 2007, the House of Representatives passed by a vote of 371 to 16 the “Industrial Bank Holding Company Act of 2007,” which would prohibit firms with more than 15 percent of their annual gross revenues from activities that are not financial in nature or incidental to a financial activity (“Commercial Firms”) from, directly or indirectly, controlling ILCs, except for certain “grandfathered” institutions. This bill also would prevent branch banking or other specified banking activities in states in which an ILC bank subsidiary had previously not had branch offices and would subject ILCs to increased supervision and examination by the FDIC.

On May 10, 2007, Senators Allard, Feingold, Johnson and Brown introduced in the Senate S. 1356, which contains very similar provisions to the restrictions included in the bill as passed by the House of Representatives.

On February 5, 2007, the FDIC had published in the Federal Register a notice extending until January 31, 2008, the FDIC moratorium on acting on deposit insurance applications and change in control notices with respect to ILCs that would be subsidiaries of companies significantly engaged in commercial activities. 72 Fed. Reg. 5290 (Feb. 5, 2007). The FDIC also had published in the Federal Register on the same day, February 5, 2007, a proposed regulation that would require holding companies that control ILCs that are not subject to federal consolidated bank supervision and are not engaged solely in financial activities, to enter into written agreements with the FDIC. The written agreements would contain eight proposed commitments, which would include consent to FDIC examination of the holding company and each of its subsidiaries, commitments to maintain the capital and/or liquidity of the ILC at levels deemed appropriate by the FDIC, and commitments to cause an independent annual audit of the ILC to be performed during the first three years after the ILC becomes a subsidiary. 72 Fed. Reg. 5217 (Feb. 5, 2007).

Another important recent development is the enactment or present consideration by a significant number of states of legislation to prohibit ILCs owned by Commercial Firms from branching into their states. We understand that Oklahoma, Maryland, Virginia, Iowa, and Missouri enacted legislation last year to bar ILCs owned by Commercial Firms from branching into their states. And we understand that in the first part of 2007, an even larger number of additional states also have been considering similar bills.

II. National Bank and Federal Savings Bank Alternatives to ILCs

What almost all of the articles tracking these ILC developments fail to analyze or mention is that existing federal national bank and federal savings bank charters may be clearly superior to ILC charters for many companies that would like to own depository institutions and engage in lending, deposit taking or other activities conducted by depository institutions.

Why is this true? Most significantly, national banks and federal savings banks can benefit from federal preemption, which makes many types of substantive state laws, regulations and policies inapplicable to nationally chartered banks and federal savings banks. Under the recent Watters Supreme Court opinion, preemption is also available for operating subsidiaries of national banks, and almost certainly as well for operating subsidiaries of federal savings banks. In addition, many state licensing and examination
requirements applicable to state-chartered depository institutions are not applicable to national banks or federal savings banks. And certain other federal statutes affecting banking, such as special interstate branching laws, provide clear advantages to depository institutions with these federal charters – as contrasted to ILCs, which either have Utah state charters or charters issued by one of the other six states that presently offer ILC charters.\(^3\)

Consistent with these federal charter benefits, certain large companies have recently acquired, or converted their depository institutions to, federal savings bank charters. For example, on March 5, 2007, the Office of Thrift Supervision ("OTS") approved applications relating to the conversion of Countrywide Bank, N.A., a national bank with over $92,000,000,000 of total assets as of December 31, 2006, to a federal savings bank to be known as Countrywide Bank, FSB. Countrywide Bank, FSB is a wholly owned subsidiary of Countrywide Financial Corporation, a leading mortgage banking company. On February 14, 2007, Blue Cross Blue Shield Association dropped its prior plan to charter an ILC and announced that, on March 1, 2007, it would open a federal savings bank, to be known as Blue Care Health Bank of Sandy, Utah. Similarly, H&R Block opened a federal savings bank, H&R Block Bank, in 2006, and by February 5, 2007 the new federal savings bank had opened more than 1,000,000 new bank accounts for its customers.

The primary disadvantage under present law to entities forming or acquiring a federal savings bank or national bank charter as contrasted to an ILC charter is the regulation of such holding companies by the OTS under the Home Owners' Loan Act as savings and loan holding companies or by the Board of Governors of the Federal Reserve System under the Bank Holding Company Act as bank holding companies with respect to the control of national bank subsidiaries that accept deposits.\(^4\) These statutory and regulatory frameworks will subject the controlling entities to detailed examination and supervision requirements, including capital requirements or oversight, on-site examinations, restrictions on investments and commercial operations and affiliate and insider transaction limitations.

However, in our experience, the aggregate impact of these statutory and regulatory frameworks is generally acceptable for financially healthy and well-managed entities that do not have significant management or financial shortcomings.

In comparison to these federal agency regulated holding companies, ILC holding companies are subject to more limited levels of holding company regulation. However, as discussed above, the legislative and regulatory changes under consideration would limit the exemptions from regulation and supervision for ILCs.

ILCs, as state chartered banks, can utilize one significant federal preemption statute to increase the interest rates and interest fees, such as prepayment fees, that they can charge with respect to loans that they make in the states in which they are located, but that are secured by properties located in other states. 12 U.S.C. § 1831d(a). If the state in which the ILC is located has permissive maximum lending interest rates and permissive interest fee limitations, such as Utah, then the ILC can charge higher interest rates and interest fees than otherwise would be permissible if the loans were made in other states in which the security properties are located. National banks and federal savings banks also can charge interest rates and interest fees permissible in the states in which they are located on loans secured by properties in other states.

There are numerous very specific differences between the national bank and the federal savings bank charters, including the specific activities authorized under each charter, that all must be carefully analyzed and evaluated. However, the general arguments presented in this client alert comparing these two bank charters to an ILC charter apply relatively similarly to both the federal savings bank charter and the national bank charter.

Lenders considering a national bank or federal savings bank charter also should be aware that there are federal law restrictions on the lending activities, particularly the mortgage activities, of federally-chartered institutions. For example, the Interagency Guidance on Nontraditional Mortgage Product Risks, released in October 2006 by the major federal banking agencies, places potentially significant restrictions on federally-chartered lenders (among others) when making interest-only loans and payment option ARMs. Most other mortgage lenders also will be subject to either the

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3 ILCs also operate in California, Colorado, Hawaii, Indiana, Minnesota and Nevada.

4 National banks that engage only in credit card activities or fiduciary activities and that do not accept deposits are not treated as “banks” for purposes of the Bank Holding Company Act.
Interagency Guidance or state law counterparts, so the restrictions in the Interagency Guidance are not unique restrictions for federally-chartered lenders. However, a lender that is considering a federal savings bank or national bank charter in order to avoid state restrictions on credit terms and underwriting practices should review carefully the Interagency Guidance and other federal restrictions to ensure that a federal charter will provide it with the flexibility that it seeks.

III. Preemption Of State Law Requirements

Under the doctrine of preemption, various state law requirements applicable to state-chartered entities, such as ILCs, are inapplicable to federally chartered entities. Substantive areas in which preemption can be particularly significant for large numbers of depository institutions include lending and especially mortgage lending, deposit taking activities, fiduciary activities and investment management activities.

On the other hand, both the Office of the Comptroller of the Currency (“OCC”) and OTS Regulations list certain subject areas with respect to which state laws affecting these subjects are not preempted in certain enumerated circumstances. These subject areas include contract law, criminal law and tort law. See, for example, 12 C.F.R. § 7.4008(e), 12 C.F.R. § 34.4(b), 12 C.F.R. § 550.136(c), 12 C.F.R. § 557.13 and 12 C.F.R. § 560.2(c).

A. Lending Requirements

Preemption of state laws is particularly valuable to lenders, such as banks and mortgage companies, that want to make loans on an interstate basis to borrowers living in different states or on properties located in different states. Required compliance with different, multiple state lending limitations and disclosure requirements obviously can result in significant administrative compliance complexities and reduced profitability resulting, for example, from interest rate limitations or purported consumer protection measures.

With respect to preemption of state lending laws, the OCC has issued detailed regulations providing that, “Except where made applicable by Federal law, state laws that obstruct, impair, or condition a national bank’s ability to fully exercise its Federally authorized real estate [and non-real estate] lending powers do not apply [or are not applicable] to national banks.” 12 C.F.R. § 34.4(a) with respect to real estate lending powers and 12 C.F.R. § 7.4008(d) with respect to non-real estate lending powers.

OCC regulations also list 14 different areas in which state law limitations do not apply to national banks making real estate loans, 12 C.F.R. § 34.4(a)(1) – (a)(14), and list 10 different areas in which state law limitations do not apply to national banks making non-real estate loans, 12 C.F.R. § 7.4008(d)(2)(i) – (x). Many of the substantive areas listed in both the real estate and non-real estate loan preemption sections are the same, such as terms of credit, escrow accounts, loan-to-value ratios, prepayment penalties and rates of interest on loans.

OTS also has issued regulations preempting state laws affecting the credit activities of federal savings banks that are similar to the OCC regulations described in the two preceding paragraphs. Specifically, Section 560.2(a) of the OTS Regulations provides in a similar manner to 12 C.F.R. Sections 34.4(a) and 7.4008(d) that, “. . . federal savings associations may extend credit as authorized under federal law, including this part, without regard to state laws purporting to regulate or otherwise affect their credit activities, except to the extent provided in paragraph (c) of this section or § 560.110 of this part.” (These two exceptions cover certain designated subject areas in which state laws are not preempted (see discussion above) and certain state laws imposing interest rate limitations.) And Section 560.2(b) of the OTS Regulations lists 13 specific areas in which state laws purporting to impose requirements on credit activities of federal savings associations are preempted. These listed areas are comparable in many respects to the areas listed in the OCC Regulations described in the preceding paragraph.

B. Examination and Supervision

Both OTS and OCC regulations provide that states cannot require licensing of, registration of, filings by or reports by creditors of federal savings banks or national banks respectively. See 12 C.F.R. § 560.2(b)(1), 12 C.F.R. § 7.4008(d)(i) and 12 C.F.R. § 34.4(a)(1). No federal statutes or regulations prohibit states from imposing similar requirements on state chartered ILCs. Therefore, a very significant benefit that federal savings banks and national banks have compared to ILCs is that if these federally chartered entities wish to conduct mortgage banking or other lending activities in multiple states, either directly or through operating...
subsidiaries, they are not required to be licensed or to register under the laws of these states to engage in these lending activities. In addition, with respect to national banks, 12 U.S.C. § 484 provides that only the OCC, which regulates and supervises national banks, may exercise “visitorial powers” over national banks. Section 7.400(a)(2) of the OCC regulations, 12 C.F.R. § 7.400(a)(2), defines “visitorial powers” to include:

(i) Examination of a bank;
(ii) Inspection of a bank’s books and records;
(iii) Regulation and supervision of activities authorized or permitted pursuant to federal banking law; and
(iv) Enforcing compliance with any applicable federal or state laws concerning those activities.

C. Deposit Account Terms And Practices

Many states have laws that regulate permissible terms for deposit accounts or require certain disclosures or information to be provided to depositors. An OCC regulation preempts most, although not all, of these state requirements for national banks. According to that regulation, “state laws that obstruct, impair, or condition a national bank’s ability to fully exercise its Federally authorized deposit-taking powers are not applicable to national banks.” OCC regulations also list various types of state laws that are preempted with respect to national banks under this standard, which include laws concerning:

(i) Abandoned and dormant accounts;
(ii) Checking accounts;
(iii) Disclosure requirements;
(iv) Funds availability;
(v) Savings account orders of withdrawal;
(vi) State licensing or registration requirements (except for purposes of service of process); and
(vii) Special purpose savings services.6

With respect to federal savings banks, Section 557.11(b) of the OTS regulations provides that, “Federal savings associations may exercise deposit-related powers as authorized under federal law, including this part, without regard to state laws purporting to regulate or otherwise affect deposit activities, except to the extent provided in § 557.13.” Section 557.12 of the OTS regulations then lists as preempted types of state laws relating to deposit activities all of the same activities listed above in Section 7.4007(b)(1) by the OCC for national banks and also includes in addition “service charges and fees.”

In contrast, federal law does not preempt any state laws regulating deposit accounts for ILCs.

D. Fiduciary Activities

One additional area of substantive banking activities that we would mention briefly here that also has been the subject of OCC and OTS preemption regulations and determinations involves fiduciary activities. In general, many state laws are preempted with respect to the conduct of fiduciary activities by federal savings associations and national banks.

For example, Section 550.136(a) of the OTS Regulations provides explicitly that “OTS occupies the field of the regulation of the fiduciary activities of Federal savings associations... Accordingly, Federal savings associations may exercise fiduciary powers as authorized under Federal law, including this part,

6 Id. Section 7.4007(b)(2) (footnote omitted). A footnote to this regulatory section explains that the regulation does not preempt “state laws of the type upheld by the United States Supreme Court in Anderson Nat’l Bank v. Luckett, 321 U.S. 233 (1944).[...]” Id. § 7.4007(b)(2)(i) n. 3. In Luckett, the Court held that a national bank had to comply with a state law that required banks to turn over deposits in an account that had been dormant for ten years. The Court reasoned that the law was in the nature of a property law dictating who had a proprietary interest in the deposits held by a bank: “[A] bank account is a chose in action of the depositor against the bank, which the latter is obligated to pay in accordance with the terms of the deposit. It is a part of the mass of property within the state whose transfer and devolution is subject to state control.” Id. at 248.

7 Section 557.13 lists as not preempted in certain situations contract and commercial law, tort law, criminal law, and any other state law if the OTS finds, upon review, that the law furthers a vital state interest and either only incidentally affects the federal savings association’s deposit-related activities or is not otherwise contrary to the preemption purposes expressed in Section 557.11.
without regard to State laws that purport to regulate or otherwise affect their fiduciary activities, except to the extent provided in 12 U.S.C. § 1464(n) . . . or in paragraph (c) of this section.**

See also 12 C.F.R. § 9.7(e)(2), which provides with respect to national banks that, “Except for the state laws made applicable to national banks by virtue of 12 U.S.C. 92a, state laws limiting or establishing preconditions on the exercise of fiduciary powers are not applicable to national banks.” For an example of an OCC legal opinion holding that Federal law preempts certain state laws purporting to limit the ability of a national bank conducting all the core fiduciary functions only at its Michigan offices from engaging in certain fiduciary activities in certain other states, see Interpretive Letter #866, dated October 8, 1999 from Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, to Julius L. Loeser of Comerica Incorporated.

** 12 U.S.C. § 1464(n), which authorizes fiduciary activities for federal savings associations, specifies certain state law requirements that are applicable to federal savings associations. Section 550.136(c) lists six types of state laws that in certain specified circumstances are not preempted with respect to Federal savings associations.

IV. Conclusion

Based upon the foregoing summary discussion, preemption can provide significant advantages to federal savings banks and national banks engaged in mortgage banking, fiduciary or other activities that are not available to ILCs, which are all state-chartered. Although the federal regulation of holding companies of national banks and federal savings banks engaged in deposit taking and other banking business can be significant, in our experience, the aggregate impact of these frameworks is generally acceptable for financially healthy and well-managed entities that do not have significant management or financial shortcomings. Therefore, companies interested in obtaining a depository institution charter and that are engaged only in activities that are financial in nature should carefully examine the national bank and federal savings bank charters as alternatives to ILC charters.