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MEMORANDUM

TO: ASSEMBLY COMMITTEE ON COMMERCE AND LABOR

FROM: DONAL HUMMER, JR., VICE-PRESIDENT AND GENERAL COUNSEL, HARLEY-DAVIDSON FINANACIAL SERVICES, INC.

SUBJECT: AB 389 (2003 SESSION)

DATE: APRIL 11, 2003

During committee hearings on AB 389, some members have expressed concern that account holders and consumers face significant risks if non-banking companies can continue to own banks, savings & loans, or thrifts. Specifically, some fear that the parent company could simply siphon funds from the bank to support the parent company's faltering operations, thereby depleting the bank's capital to dangerously low levels. We believe these fears are unfounded.

To begin, no reasonably run bank or thrift would engage in such tactics. In any event, the banking industry is closely scrutinized. It is examined more frequently and carefully by federal and state regulators than almost any other industry. A long list of regulations and laws govern the financial well being of banks and thrifts, and restrict their ability to funnel capital to a parent company. This memorandum will summarize many key regulations and laws on this topic. In light of the highly regulated environment in which banks and thrifts operate, there is no realistic chance that the fears expressed by some would actually come true.

Regulation W Restricts Transactions Between a Bank and Affiliated Entities.

Federal Reserve Regulation W is a complex series of regulations affecting almost any bank or thrift. These regulations apply to any national bank, state bank, banking association, or trust company that is a member of the Federal Reserve System. Regulation W also applies to all FDIC-Insured state non-member banks, and all FDIC-insured savings associations. The following summary of Regulation W is not an exhaustive analysis, but is simply intended to show that federal regulations severely restrict a bank's ability to divert funds to its parent company, or to any other related entity. Regulation W went into effect on April 1, 2003.

Regulation W restricts certain transactions between a bank and its affiliated companies. (*See*, 12 C.F.R. §§223.1 through 223.71). "Affiliated companies" or "affiliates" are very broad terms. The terms include any entity which controls a bank, any company that is controlled by a company that controls a bank, and any company in which a majority of the directors, trustees, or general partners, also constitute the majority

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of directors, trustees, or general partners of a bank. (*See*, 12 C.F.R. §223.2 for complete list). Regulation W also restricts transactions which are used for the benefit of, or transferred to, an affiliate.

On a general level, all transactions between a bank and its affiliates must be consistent with "safe and sound banking practices," and must be on "market terms." Regulation W also imposes a whole host of specific limitations on transactions between a bank and an affiliate, which are far too numerous to list here. For example, a bank cannot initiate a covered transaction (such as a loan, or an advance of funds) with an affiliate, if the transaction would cause the total amount of that bank's transactions with that affiliate to exceed 10 % of the bank's capital stock and surplus, or would cause the total amount of the bank's transactions will all affiliates to exceed 20% of the bank's capital. Therefore, Regulation W places severe restrictions on a bank's ability to divert capital and funds to its parent company.

Additionally, if a bank extends certain types of credit to an affiliate, the loan must be secured by a statutorily defined amount of collateral. The type of collateral that the bank can accept is also governed by Regulation W. Further, a bank cannot purchase a "low-quality" asset from an affiliate. A "low-quality" asset is defined in detail by Regulation W.

In sum, the consistent theme arising from Regulation W is that federal regulators will continue to watch banks and thrifts very closely. Regulators will examine any transaction that even hints that a bank might have improperly funneled funds to a parent or other associated entity. As evidence of this strong intent, federal regulators have been given the following marching orders in enforcing Regulation W: "Reviews for compliance with the affiliate transaction rules should be frequent and rigorous, and any violations or potential violations should be resolved quickly." (January 9, 2003 Memorandum from Richard Spillenkothen, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, to each Federal Reserve Bank).

Banks and Thrifts are Subject to Minimum Capital Requirements.

Any financial institution insured by the Federal Deposit Insurance Corporation (FDIC) must maintain a certain amount of capital, as mandated by the FDIC. (*See*, 12 C.F.R. §§325.1 through 325.105). Again, few other industries (if any) have federally-imposed capital requirements.

Failure to maintain the capital requirements can result in disciplinary action against the bank, and in drastic cases, the FDIC may appoint a receiver to run the bank. (12 U.S.C. §1818; 12 C.F.R. §325.4). Since banks and thrifts must maintain a certain level of capital at all times, their ability to divert funds improperly to a parent company is significantly restricted.

These regulations also state that the parent company of a federally insured bank must guarantee performance of that bank. In short, the parent company can be held financially responsible (within certain limits), if a bank or thrift fails to meet its capital requirements. (12 C.F.R. §325.104).

Most Deposit Funds are Insured By The FDIC.

The most well known safety net which protects consumers is FDIC insurance. Most consumer banking accounts, such as savings accounts, checking accounts, and certificates of deposit, are insured by the FDIC against loss, in the amount of $100,000 per depositor. Therefore, even if a bank or thrift were to divert funds improperly, and subsequently go out of business, consumers would have a substantial amount of protection.

Regulation "O" Limits the Amount a Bank May Lend to Senior Executives, Directors, and Affiliates.

Federal Regulation "O" is another set of regulations which restricts the ability of a bank or thrift to channel funds to a parent corporation. (*See*, 12 C.F.R. §215.1 through 215.23). Regulation O governs any extension of credit to an executive officer, director, or principal shareholder of that bank, as well as the extension of credit to an "affiliate" of the bank (defined as a corporate parent, and the parent's subsidiaries).

Among other things, a member bank may not extend credit to a bank "insider" or to any of its affiliates unless three conditions are met: (1) the extension is made on the same terms as other loans and in accordance with underwriting procedures used for other loans; (2) the loan does not involve more than the normal risk of repayment; and (3) the loan does not present other unfavorable terms. (12 C.F.R. §215.4).

Regulation "O" also sets a limit on the aggregate loan amount allowed to insiders of the bank or to the bank's affiliates. If the loans exceed a certain amount, or a certain percent of the bank's capital surplus, the board of directors must pre-approve the loan. (12 C.F.R. §215.4). There are also a number of disclosure requirements, to ensure that loans made by a bank to an insider or affiliate are made public. (12 C.F.R. §215.11).

Nevada Already Has an Extensive Regulatory Scheme In Place To Protect Consumers.

The State of Nevada has a wide-ranging statutory and regulatory scheme in place. For example, Nevada Revised Statutes sections 677.010 through 677.850 govern "Thrift Companies." The Nevada Administrative Code also includes a series of regulations which govern Thrift Companies. (NAC §§ 677.010 through 677.550).

These statutes and regulations impose many of the same restrictions as their Federal counterparts. For example, Nevada-chartered thrifts must maintain minimum capital requirements (NAC §§677.150 through 677.270). Moreover, Nevada thrifts are

restricted in the types of loans they can offer to their officers, directors, or any entity which owns 10% or more of the thrift. (NRS §677.650).

Banks and Thrifts are Audited Regularly.

To ensure compliance with the vast number of laws and regulations governing banks and thrifts, state and federal bank examiners regularly audit these institutions. Pursuant to Nevada law, all Nevada-chartered thrifts are examined at least once a year. (NRS 677.430).

Under Federal regulations, officials examine FDIC-insured institutions frequently. While federal regulations do not set a defined examination schedule (i.e., once a year/twice a year), formal on-site examinations are conducted regularly. During these examinations, FDIC officials grade each financial institution on factors such as capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. Moreover, all FDIC-insured institutions must submit quarterly financial data to the FDIC, as well as audited annual reports. (*See, e.g.*, 12 C.F.R. §§363.4, 584.1).