

**DEVELOPMENTS IN ELECTRONIC COMMERCE:
OTS DEVELOPMENTS**

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I. Internet Banking

A. Regulatory Implications of the Internet-only Bank¹

1. Greater Capital for what are now Perceived to be Greater Risks

a. The basic premise of these institutions has not been proven as yet:

- (1) although they have eliminated the costs associated with a branch structure, they have very high costs of acquiring and retaining customers;
- (2) they tend to have a high cost of funds and the funds they attract are "hot" money, quick to leave if another institution offers a higher rate; and
- (3) customers are not comfortable conducting the entire mortgage loan process on-line. For most people, this is the most important financial transaction they will ever enter into and they want to deal with a person face-to-face at some point in the process.

b. OTS continues to be receptive to the concept, but in view of the risks, and particularly of the high start-up costs associated with attracting customers, it imposes higher capital requirements on Internet-only banks.

¹ Eight of the fifteen existing Internet-only banks are federal thrifts.

B. Old Economy/New Economy

It may be that, as in other sectors of the economy, the current story in the development of the Internet is the adoption of the Internet by “old economy” businesses, rather than the development of any killer applications by Internet-only banks. Approximately one half of all thrifts have informational web pages and one quarter of all thrifts have transactions web sites.

C. CRA Implications of Branchless Banks

1. CRA requires banks to meet the credit needs of its “community”, including the needs of LMI neighborhoods.
2. The notion of a bank’s “community” developed in the era of bricks and mortar and still made sense after interstate banking.
3. Credit card banks were the first challenge to the paradigm: they were organized in Delaware, but were not permitted to compete for deposits and loans in Delaware. The regulatory solution was not to adjust the concept of “community”, but to require a different sort of performance—community development activities rather than direct lending.
4. The 1993-95 revision of the CRA regulations, although it occurred at a time when branchless banking was achieving prominence, did not address the issuer directly.
 - a. In the case of credit card banks and other limited purpose banks, it made a sensible adjustment: as long as the bank has met the credit needs of its assessment area, the regulators will consider community development activities outside of the assessment area.
 - b. But for branchless banks that offer a variety of services, the only alternative was the strategic plan: a nebulous concept. The plan is subject to public comment and must contain “measurable goals for helping to meet the credit needs of the assessment areas covered by the plan”.
5. The OTS Approach
 - a. Ellen Seidman: traditional approach means there is little incentive to meet the needs of LMI borrowers outside the assessment area (where most of the bank’s activity occurs).

- (1) One approach would be to apply the limited purpose bank approach to a broader category of banks, but that is not satisfactory to her because the community development test does not require the provision of direct loans in the assessment area.
- (2) Customer based assessment area (the “entire customer base without regard to geographic proximity”)
 - i. CRA regulations only provide it for military personnel, but it could be expanded
 - ii. This is, in effect, the approach that the OTS has taken in chartering such thrifts: in addition to CRA Activities in the assessment area, such thrifts are expected to voluntarily establish goals for lending to LMI borrowers outside their assessment areas.

II. Developments in Holding Company Regulation

A. The Implications of Gramm-Leach Bliley Act

1. Although the intent of GLB Act was to bring financial services businesses under one tent, with the Fed as the umbrella regulator, the unitary thrift holding company continues to provide an alternative, and in many ways less restrictive regime.
2. GLB did prevent the establishment of additional thrift holding companies that are engaged in nonfinancial activities, but many companies got in under the wire and are grandfathered.
3. Thrift holding companies formed after GLB are not unrestricted in their affiliations, but can engage in all types of financial activities while being subject to less regulation than financial holding companies.

B. OTS Regulation of Holding Companies

1. In the past, OTS regulation of thrift holding companies has been very light. In addition to the absence of restrictions on affiliate activities, there were no capital requirements applicable to thrift holding companies and examinations were typically went no further up the corporate chain than the shell holding company above the thrift.

2. However, one of the most important developments with regard to the OTS is the increase in holding company regulation. Like other OTS developments, this change is being implemented through the application and supervision process rather than through the promulgation of new regulations.
3. Reasons for the Change: The Phantom Thrift
 - a. Many companies that come to the OTS for a charter really do not want much more than a charter. They are already engaged in a business (mortgage lending, or trust services, for example) and do not want to create a new infrastructure.
 - b. What they want are the benefits of the thrift charter:
 - (1) preemption of state laws, which makes it much easier to operate on a nationwide basis by obviating compliance with state licensing and substantive legal restrictions; and,
 - (2) in some cases, cheap funding.
 - c. In addition, many of these organizations already conduct their businesses by locating employees and functions in a particular legal entity for tax and other reasons, while utilizing them to provide services to other parts of the organization. Examples include the use of captive insurance agents to sell consumer loan products; funding a thrift by having an affiliate purchase all its credit card receivables; or simply the use of centralized administrative staff to provide tax, accounting, legal and data processing services.
 - d. If permitted, many of them would take the charter, put it in a drawer and run their business as they have in the past. Not surprisingly, this is not acceptable to the OTS. The OTS will require that the thrift have a certain amount of dedicated staff. The requirement will vary depending on the nature of the thrift's activities, the size of its business and so forth, but some core staff will be required. Nevertheless, the OTS will permit the thrift to rely to a significant extent on personnel located in other parts of the organization and, subject to the requirements of Section 23A and 23B, to engage in a substantial amount of transactions with affiliates.

e. The high degree of integration between the operations of many of the new thrifts and their affiliates has forced the OTS to take a closer look at those affiliates and the parent holding company.

4. The New OTS Approach to Holding Company Supervision²

a. Rigorous review of applications to establish a thrift holding company

(1) Careful review of business plans, capital structure, managerial expertise and overall integrity

(2) In the absence of consolidated capital regulations, focus is on assessing capital at the time the company establishes the thrift

(3) “If the applicant plans to rely on a network of agents and brokers for referral business, we make sure that proper controls are in place and that these representatives will receive comprehensive training.”

(4) This is a tailored approach, which takes into account:

i. The overall risk profile of the consolidated entity and of the subsidiary thrift

ii. Extent of managerial and board overlap

iii. The amount and nature of transactions with affiliates

b. More intensive on-site examination and evaluation of prospective holding company risk

c. Close communication and prior notification of significant transactions. The OTS is considering a proposal that would require prior notice from many savings associations and thrift holding companies before then incur substantially more debt, or

² Ellen Seidman, Director, Office of Thrift Supervision, 11th Annual Seminar on International Finance (Sept. 20, 2000).

enter into a transaction that would markedly increase consolidated assets or reduce capital below a specified level.

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