S. HRG. 110–950

EXAMINING THE REGULATION AND SUPERVISION OF INDUSTRIAL LOAN COMPANIES

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

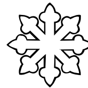
FIRST SESSION

ON

THE REGULATION AND SUPERVISION OF INDUSTRIAL LOAN COMPANIES

THURSDAY, OCTOBER 4, 2007

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



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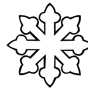

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C O N T E N T S

THURSDAY, OCTOBER 4, 2007

Page

Prepared statement of Chairman Dodd ... 47
Opening statements, comments, or prepared statements of:
- Senator Brown ... 1
  - Prepared statement ... 47
- Senator Shelby ... 2
- Senator Johnson ... 4
  - Prepared statement ... 48
- Senator Bennett ... 4
- Senator Tester ... 7
- Senator Bunning ... 7
- Senator Crapo ... 8
- Senator Reed
  - Prepared statement ... 49

WITNESSES

Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System ... 10
- Prepared statement ... 154

John Bovenzi, Chief Operating Officer and Deputy to the Chairman, Federal Deposit Insurance Corporation ... 12
- Prepared statement ... 170

Scott M. Polakoff, Senior Deputy Director, Office of Thrift Supervision ... 13
- Prepared statement ... 187

Erik Sirri, Director, Division of Market Regulation, Securities and Exchange Commission ... 15
- Prepared statement ... 196

Edward Leary, Commissioner, State of Utah Department of Financial Institutions ... 17
- Prepared statement ... 203
- Response to written questions of:
  - Senator Shelby ... 323
  - Senator Crapo ... 324

Edward L. Yingling, President and Chief Executive Officer, American Bankers Association ... 31
- Prepared statement ... 223

Marc E. Lackritz, President, Securities Industry and Financial Markets Association ... 32
- Prepared statement ... 237

Arthur E. Wilmarth, Jr., Professor of Law, George Washington University Law School ... 34
- Prepared statement ... 247

Peter J. Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute ... 36
- Prepared statement ... 293

Brigid Kelly, Political Director, Local 1099, United Food and Commercial Workers International Union ... 38
- Prepared statement ... 306
- Response to written questions of:
  - Senator Reed ... 326

Page

Jagjit "J.J." Singh, Chairman, President, and Chief Executive Officer, Transportation Alliance Bank 40
Prepared statement 315

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Letter from E.J. "Jake" Garn, former U.S. Senator from the State of Utah, to Chairman Dodd 328

EXAMINING THE REGULATION AND SUPERVISION OF INDUSTRIAL LOAN COMPANIES

THURSDAY, OCTOBER 4, 2007

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Senator Sherrod Brown, presiding.

OPENING STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. The Committee will come to order. Good morning to everyone.

Thank you all for joining us here today as the Committee examines the role that industrial loan companies play in our banking system. That system, as we know, is a continually changing one as lenders innovate and Congress from time to time responds to changes in the landscape. Amidst this change, some principles remain constant. Four times in my lifetime, Congress has acted to separate commercial firms from banks and vice versa. Truth be told, I really was not paying particularly close attention to the passage of the 1956 Bank Holding Company Act. Time and again we have seen the real costs when Congress has failed to act, from the Depression to the savings and loan crisis. Frankly, we are seeing variations of the problem today. In Japan, the intermingling of commerce and banking has led to disastrous results, and here at home, where the subprime mortgage meltdown has operated largely outside of Federal supervision.

I have been pretty candid all year about what I think has been the failure of the Federal Reserve to act more aggressively to police the subprime, non-bank lenders. It would not be inaccurate if our witness from the Fed made the same observation about Congress and the ILCs. But I suppose it would be impolite. We need to act this fall to address this problem, just as we have repeatedly in the past. When commercial firms set up single-bank holding companies, Congress amended the law in 1970 to reach them. When commercial firms started buying non-bank banks, Congress in 1987 stepped in again. When commercial firms started to acquire thrifts, Congress responded with Gramm-Leach-Bliley in 1999.

In this spring, in the wake of the tremendous growth in industrial loan company assets since Gramm-Leach-Bliley almost eightfold, the House adopted Representative Paul Gillmor's bill to prevent further commercial acquisitions of ILCs by a vote in the House of 371–16. The strength of that vote is a small testament to

the respect in which Paul Gillmor was held and the skill with which he did his job as a legislator.

Paul and I served in Columbus together, he in the Senate, I in the Lower House in those days, where he had a reputation as a solid legislator, but it was when we both moved on that our paths crossed. I was serving as Secretary of State in 1988 when Paul ran for the open congressional seat in northwest Ohio. Paul won that primary by initially 35 votes. I as Secretary of State was called in to conduct the recount, running against the son of the retiring Congressman, Paul's opponent, and I remember saying to my elections counsel, "Make sure you do this one well because the winner of this Republican primary in this Republican district is going to be in Congress for the next 20 years."

I was off by a year, but I sure wish I had been off by a lot more. Congress lost a real expert on these issues, and Karen Gillmor and the rest of his family and friends lost a good man. I hope we can pick up where he left off.

Senator Shelby.

OPENING STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Chairman, I am going to have to leave this hearing because we have on the floor of the Senate, as you know, the Commerce, Justice, and Science appropriations bill, and I will be helping manage that with Senator Mikulski, but I do have an opening statement that I want to give. And, Mr. Chairman, I have a number of questions that I would like to submit to the panel for the record, and my staff will handle that.

Thank you, Mr. Chairman, for holding this hearing. Today we examine the regulation and the supervision of industrial loan companies, or ILCs. The topic raises at least three critical questions which this Committee should consider carefully.

First, to what extent, if any, should we allow the continued mixing of banking and commerce through commercial ownership of banks?

Second, is a consolidated supervisory approach rather than a more bank-centric approach the optimal method for regulating our financial institutions?

Third, should we charge the Securities and Exchange Commission with the additional responsibilities of a prudential supervisor?

Although the decision by the FDIC to extend the moratorium on ILCs owned by commercial companies gave a certain impetus to today's hearing, the issue is not new here. In 1987, this Committee passed the Competitive Equality Banking Act, or CEBA. While CEBA eliminated further chartering of non-banks, it exempted a number of entities from the requirements of the Bank Holding Company Act. Among those entities were credit card companies, trust companies, and ILCs.

Twelve years later, we revisited the issue of regulatory modernization in the Gramm-Leach-Bliley Act. Gramm-Leach-Bliley ended the ability of unitary thrift holding companies, we will remember, to engage in bank-like activities if they were owned by non-financial businesses. But Gramm-Leach-Bliley did not address

the exemption of ILCs and their holding companies from Fed supervision.

Other than certain grandfathered unitary thrifts and non-bank banks, this meant that the ILCs were the only option for commercial firms to accept insured deposits and make consumer and commercial loans. In the meantime, ILCs gained in popularity. Between 1987, when CEBA was enacted, and 2004, total assets held by ILCs rose 3,500 percent.

The mixing of banking and commerce, as the Chairman noted, raises a number of issues which this Committee must review carefully. Perhaps the most significant concern is the potential for conflicts of interest on the part of commercial owners of a bank which would jeopardize the bank's federally insured deposits.

As we consider the supervision and the regulation of ILCs, I believe we must be mindful of the history of the separation of banking and commerce and the legislative exceptions to such separation that the Congress has created over the years.

In addition to concerns about the mixing of banking and commerce, the ILC debate also raises questions about the optimal regulatory structure that I alluded to earlier. While the vast majority of assets in our banking system are subject to consolidated supervision, a significant minority have been regulated through a more bank-centric approach. Until recently, the FDIC had generally defended the adequacy of the bank-centric approach to regulation. I think we should consider the merits of both approaches, including the history of bank failures under each approach.

This leads to a final question. Should the Gramm-Leach-Bliley Act be revisited to give the SEC statutory authority as a consolidated supervisor? Despite the fact that Congress did not, as I mentioned, provide this explicit authority to the Securities and Exchange Commission in Gramm-Leach-Bliley, the SEC has put in place a version of this authority through its own rulemaking. I do not believe it would be appropriate to ratify the SEC's consolidated supervisory entities program as an afterthought to the ILC debate.

If some form of a consolidated supervision for unregulated broker-dealer affiliates and holding companies is needed, we should thoroughly right here consider such a change before it is codified in statute. In any event, we should not forget the careful balancing that went into crafting our current functional regulatory scheme.

These issues are important ones for this Committee with profound implications for the safety and soundness of our financial institutions, the future of financial regulation as we know it, and our banking system as we know it today. As we move forward, each of these issues will require the full resources and attention of this Committee, as well as the cooperation of the regulators.

I thank the Chairman for calling this hearing. I hope it is the first of many hearings addressing this profound, complex, and fundamental issue surrounding this important topic.

Thank you, Mr. Chairman.

Senator BROWN. Thank you, Senator Shelby.

Senator Johnson, would you like to—and I would add, Senator Johnson was very involved in this issue before I came to the Senate, and he and I worked together on this late last year as we prepared for all of this. Senator Johnson.

OPENING STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Mr. Chairman, I will submit my statement for the record. Thank you.

Senator BROWN. Thank you.

Senator Bennett, for an opening statement.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you very much, Mr. Chairman. I appreciate both the hearing and your courtesy in allowing me some input as to who would be invited here.

I want to welcome Commissioner Ed Leary from Utah. Commissioner Leary began his time as the Commissioner of the Utah Department of Financial Institutions in the same year that I was elected to the Senate, so we have been wrestling with this question now in tandem for about 15 years.

This is obviously a subject of great interest to me because Utah has a number of ILCs chartered in our State. We are not the only State that charters ILCs, but we have, we believe, the best, well-established regulatory structure and safe and sound record. There has never been an ILC chartered in Utah that has failed, and this is neither by accident nor loophole.

As I look at the record and legislative history of the ILC Charter, I see a different picture than that that many others see. Legislation is usually the solution to a problem. It seems to me that restrictive legislation on ILCs is a solution in search of a problem. The ILC Charter has a sterling record. We have not had a failure, as I say, of a commercially affiliated ILC.

Now, some who are opponents of the ILC say, “Yes, but what if Enron or WorldCom had owned an ILC?” That is an interesting theoretical question. Let’s look at the factual record.

Tyco and Conseco both did own ILCs when they ran into serious trouble. Tyco’s ILC was successfully spun off in its own public offering, and the Conseco ILC, with the parent in bankruptcy, was walled off, and the assets were sold for a profit, not a loss.

The record of the ILCs clearly shows that they are among the safest and most well-capitalized financial institutions in the country, and that also is not by accident. The FDIC, for those that are headquartered in Utah, in partnership with the Utah Department of Financial Institutions, rigorously regulates the ILC Charter, and they are subject to the same safety and soundness, consumer protection, deposit insurance, CRA, and other requirements as all the other FDIC-insured depository institutions. They are subject to many of the same requirements as bank holding companies such as strict restrictions on transactions with their bank affiliates, and their parent companies are subject to prompt corrective action and capital guarantee requirements if the banks they control encounter financial difficulties.

In some instances, they are subject to firewalls and corporate governance restrictions that exceed those available to bank holding companies, and these tools, in the words of the former Chairman of the FDIC, Donald Powell, allow the FDIC to manage the relationships between industrial loan companies and their owners “with little or no risk to the deposit insurance funds and no subsidy transferred to the non-bank parent.”

I want to stress that because there has always been an assumption there that there was some kind of subsidy to the parent that went with owning an ILC, and as Chairman Powell makes clear, that is, in fact, not the case.

The current Chairman of the FDIC, Sheila Bair, has said, "ILCs have proven to be a strong, responsible part of our Nation's banking system's innovative approaches banking. Many have contributed significantly to community reinvestment and development. The record to date demonstrates that the overall industry has operated in a safe and sound manner and that the FDIC has been a vigilant, responsible supervisor of that industry."

The ILCs exist to serve niches that the rest of the banking system does not serve and, therefore, has a limited-purpose charter. Let's look at the size of those niches.

The ILCs amount to 59 of almost 8,700 insured depository institutions in this country and control only 1.8 percent of the assets. Of the 59 existing ILCs, 15 are controlled by a commercial parent, the others by a financial parent. This is not threatening the stability of the banking system even if it were weak, which it is not.

I also believe the legislative history is very clear. You, Mr. Chairman, have referred to that, as has Senator Shelby. Let's go through it a little bit again.

The ILC Charter is not a loophole charter. It is a recognized and intentional exception to the Bank Holding Company Act. There are many exceptions that have and continue to exist. The Bank Holding Company Act has evolved from a broadly permissive system of bank commercial affiliations. The current law restricts but does not prohibit such affiliations.

From 1956 to 1970, BHCA covered only companies that controlled multiple banks. Thus, BHCA allowed any company, including a commercial firm, to control a single bank. Although the one-bank holding company exemption was repealed in 1970, the BHCA continues to this day to cover only companies that own banks. This exempts individuals, families, and other non-corporate entities from the act, allowing, among other things, community banks to be owned by individuals who also own commercial businesses.

If I can put it on a more humble example, your local banker whose family owns the local bank could also own the car dealer, the hardware store, and the drycleaner, and that would not be a violation of BHCA. Combining banking and commerce in this fashion is commonplace across America. We also have other limited-purpose banks that are exempt from the BHCA, like the one owned and operated by the Independent Community Bankers of America. We have never had a bright line separating banking and commerce.

Talk about Gramm-Leach-Bliley? It did eliminate the continuation of the unitary thrift charter, mostly due to the rumor that a certain large retailer was seeking to acquire one. But that was not a reaffirmation of a bright line separating banking and commerce. In fact, ILC powers and the powers of other limited-purpose charters that permitted commercial affiliations were expanded in Gramm-Leach-Bliley. And I go, as my source for that, to the principal author of Gramm-Leach-Bliley—Senator Gramm—who sat as Chairman of this Committee.

He made this comment to the American Banker in February of 2006 when he sat down for an interview. He was asked about the statement he made on the day Gramm-Leach-Bliley was passed when he predicted that within a decade, another banking law would eliminate any remaining walls separating banking and commerce. In the interview, he stated that he believed that was inevitable. Quoting him, "American banks are competing with banks around the world that have varying degrees of commercial powers so, clearly, that is going to happen. The pressure comes from a growing recognition that this is the way business is done financially in the world, and that if we are going to compete successfully, we have got to play by the same rules."

Now, it is clear that Senator Gramm did not believe that Gramm-Leach-Bliley was or should be perceived as a reaffirmation of a bright-line separation of banking and commerce. And I have talked to him specifically about ILCs, and he says, "If you want me to, I will come down and testify in favor of the current ILC Charter in my role as the principal author of Gramm-Leach-Bliley."

All right. In closing, I do not believe that an entire class of financial institutions, which the record clearly shows are well managed, well capitalized, well regulated, and that provide great benefits to niches of customers in all 50 States, should be eliminated or strangled by regulation or law because of who their owner is. The ILCs are permitted to be owned by commercial companies. They are not committed to be the piggy bank of the commercial parent. There are very strict rules and regulations which are vigorously enforced relating to transactions between the ILC and the commercial parent. And most of the concerns I have heard expressed regarding the ILC Charter are hypothetical and would currently be prohibited by existing law and regulations.

I have had a conversation with Chairman Rangel where he expressed concern about Home Depot using an ILC to tie purchases at Home Depot to the loans available in the ILC, and I said, "Mr. Chairman, that is illegal now." And his staff had not been aware of that fact. And, indeed, Home Depot has a credit card where they take advantage of people coming into Home Depot, seeking credit support for their purchases, and that is legal now, and the ILC activity would have no impact on that whatsoever.

So, Mr. Chairman, I am happy to have this hearing. I look forward to talking with you and my colleagues more about ways to clarify the existing limited-purpose nature of ILCs. But I am not inclined to consider overturning existing law to prevent commercial companies from affiliating with ILCs. The track record has been very strong, and the advantages that have come from commercial companies with their ILCs I think will be illustrated by some of the witnesses we will have here today.

So, with that, Mr. Chairman, I thank you for the hearing and look forward to the witnesses that we will have come before us.

Senator BROWN. Thank you, Senator Bennett.

Senator Tester, for an opening statement, if you choose.

STATEMENT OF SENATOR JON TESTER

Senator TESTER. Thank you, Chairman Brown. I appreciate you calling this hearing together, and I also want to thank Senator Johnson for his interest in the matter.

ILCs go back nearly a hundred years, and I look forward to this hearing to find out more about them, because I will be the first to tell you I do not know all of the intricacies of it. But it appears to me—and Utah may be doing a great job, but it appears to me that they are—well, to have the SEC, the FDIC, the OTS, and the Federal Reserve all having oversight really does not sound like a logical, coherent framework to me. And to compound that, I have heard from a bunch of bankers in my State of Montana, and I can tell you that the banking and the individual banks around the State of Montana have played a critical role in making Montana what it is today, in a positive sense.

And so when they start expressing their concerns, it brings up my antennas, and I just appreciate this hearing to learn and hopefully, if there are problems, to fix those problems.

So, with that, Mr. Chairman, once again thank you for having the hearing.

Senator BROWN. Thank you, Senator Tester.

Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman Brown. So many different Senators have chaired meetings this week, I am wondering when it will be my turn.

[Laughter.]

Senator BROWN. I have waited a long time for this, Senator Bunning, frankly.

[Laughter.]

Senator BUNNING. Rightly so.

Senator BROWN. Perhaps, perhaps.

Senator BUNNING. This is your first year here.

Senator BROWN. Yes, but I waited a long time somewhere else. Let's not get into that, Senator Bunning.

[Laughter.]

Senator BUNNING. We have all heard a lot from folks back home about this issue. It is important to more than just traditional banking interests and touches many of the key issues related to banking regulation.

Some of my colleagues were in the Congress during the savings and loan crisis, but many were not. I remember that time and what the bailout cost the taxpayers and the economy. We must not allow that to happen again.

That is why the banking system in the United States has strong regulation and some separation between banking and other functions. In order to protect our banking system, we must ensure appropriate regulation and oversight and proper separation. At the same time, we must be careful not to disrupt innovation in banking. We should not create an unlevel playing field based solely on when a company applied for a bank charter. Where and how we draw the lines must be chosen with great care.

I look forward to hearing from our witnesses and other Members of the Committee. Thank you.

Senator BROWN. Thank you, Senator Bunning.

Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Chairman Brown. I appreciate the fact that we are holding this hearing. I think that we need to pay a lot more attention to the ILC issue and, frankly, a lot of other regulatory issues. For my opening statement and any questions I might have an opportunity to ask, I am going to focus on a broader context.

The reason we are here talking about the ILC issue is because we have problems with regard to—or let me put it this way: We have disagreements over who should be the regulator and what the rules should be for those who are regulated in different aspects of our commercial and banking system.

As you may know, I worked very hard in the last few years and last year, or the last Congress, was successful when we finally got a reg relief bill through to kind of simplify and try to bring some relief to the financial industries in terms of the regulatory system with which they are faced.

We got a lot done in that bill, but we also identified a lot more that needs to be done, and we are working now on what I call Reg Relief II to try to move further into the arena. But the ILC issue is just one example, probably a very significant example, that highlights the broader issue of the regulatory system we have in place for financial industries in the United States. The current structure we see has multiple regulators and multiple charters and creates the potential for those who are regulated in one instance or another to have an advantage or a disadvantage over others in the system. And, again, the very reason we are here holding this hearing on ILCs is we have that structure.

In the near future, the GAO is going to be submitting two reports to Congress that were mandated by the Reg Relief Act. The first report will be on the volume of currency transaction reports filed with the Department of Treasury, including, if appropriate, recommendations for changes to the filing system.

The second report will discuss measurements of regulatory costs and benefits and efforts to avoid excessive regulatory burdens, the challenges posed to financial regulators by trends in the industry, and options to enhance the efficiency and effectiveness of the Federal financial regulatory structure. And it is my hope that this Committee will very seriously consider these two reports.

I think the second report in particular will be timely in discussing the ILC debate in the broader context of reviewing our regulatory structure. Along with examining the regulation and supervision of industrial loan companies, we need to examine and consider how to modernize our Federal financial regulatory system. Our financial regulatory structure continues to be challenged by the industry trends that increased consolidation, conglomeration, convergence, and globalization. The financial services firms that offer similar products are often subjected to different regulatory regimes, creating the potential for inconsistent regulation.

To address this issue and to improve their competitive position globally, some nations have now reorganized their regulatory systems, and some have even consolidated their regulators into a single regulatory agency while others have created specialized regulatory agencies that focus solely on ensuring the safety and soundness of institutions or on consumer protections.

I am hearing a lot of talk and praise about Britain's approach to regulation as a model for effective but not onerous systems that oversee banks, brokers, investment funds, and a system, frankly, that could improve the competitive position of U.S. markets and financial markets globally. I am very interested in the principles-based approach to regulation, similar to the FSA in Britain, and I intend to focus my time in this hearing in addressing those issues.

Mr. Chairman, I do not know if that is exactly the direction we need to go, but I do know that we need to address the complex, convoluted regulatory system that we have in the United States today in an effort to simplify it and avoid these kinds of circumstances where we have different parts of the industry very intensely competing to be sure that they are not put at a disadvantage or in some contexts be sure that they do get an advantage over others who are performing similar functions in the system.

So, again, I appreciate the focus of this hearing today on the ILC issue. I hope that this Committee will expand and continue our effort to focus on reg relief efforts in the future, and hopefully we will be able to modernize and improve our regulatory structure in ways that go far beyond the current issue of just the ILC debate.

Thank you.

Senator BROWN. Thank you, Senator Crapo.

I want to call up the first panel of witnesses: Scott Alvarez has been General Counsel at the Federal Reserve Board since 2004. Mr. Alvarez joined the Board in 1981 as a staff attorney, became a senior attorney in 1985. He earned a B.A. in economics from Princeton in 1977 and a J.D. from Georgetown University Law Center in 1981.

John Bovenzi is the Deputy to the Chairman and Chief Operating Officer of the Federal Deposit Insurance Corporation. Mr. Bovenzi has worked at the FDIC since 1981, when he joined the agency as a financial economist. Since then he has served in a number of positions, including as Director of Division of Resolutions and Receiverships, Deputy Director of the Office of Research and Statistics, and Special Assistant to FDIC Board Member C.C. Hope, Jr. Mr. Bovenzi holds a B.A. in economics from the University of Massachusetts, and M.A. and Ph.D. degrees from Clark University in Worcester, Massachusetts.

Scott Polakoff has been the Senior Deputy Director and Chief Operating Officer, Office of Thrift Supervision, since 2005. Prior to joining OTS, Mr. Polakoff served 22 years with the FDIC in many capacities, including an FDIC review examiner in the Dallas Region, assistant to the Executive Director in Washington. He most recently was Regional Director, Division of Supervision and Customer Protection in the FDIC's Chicago office.

Erik Sirri is the Director of the Division of Market Regulation at the Securities and Exchange Commission. He served as the SEC's Chief Economist from 1996 to 1999. From 1989 until 1995, he

served on the faculty of the Harvard Business School. Dr. Sirri holds his Ph.D. in finance from the University of California, Los Angeles, an M.B.A. from the University of California, Irvine, and a B.S. in astronomy—astronomy?—from the California Institute of Technology. One of them.

[Laughter.]

Edward Leary was appointed Commissioner of the Utah Department of Financial Institutions in June 1992. He joined the department in 1977 as an examiner and held positions as industry supervisor and chief examiner before his appointment as Commissioner. Commissioner Leary serves as Chairman of the Board of Financial Institutions and is the Past Chairman of the Conference of State Bank Supervisors. Commissioner Leary holds his B.S. in political science and an M.B.A. from the University of Utah. He retired in 1995 as a captain in the U.S. Naval Reserve.

Before hearing your oral testimony, Senator Reed, do you want to make an opening statement? If you do, we can——

Senator REED. Mr. Chairman, let me put my statement in the record and proceed to the witnesses.

Senator BROWN. Thank you for that.

I want to remind all the witnesses that your oral statements must be under 5 minutes. Time is tight today, so we will enforce that 5-minute rule. Your entire written statement, of course, will be part of the record. We look forward to your testimony.

Mr. Alvarez, please begin.

STATEMENT OF SCOTT G. ALVAREZ, GENERAL COUNSEL, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. ALVAREZ. Thank you, Chairman Brown and Senator Bennett, Members of the Committee.

Senator Johnson, we are particularly inspired by your return to the Committee and to this issue.

I am pleased to testify before this Committee on behalf of the Board regarding industrial loan companies. ILCs are State-chartered banks that have access to the Federal safety net, and they exercise virtually all the powers of commercial banks. Nevertheless, ILCs currently operate under a special exception to the Federal Bank Holding Company Act. This special exception allows any type of firm, including a commercial firm or foreign bank, to acquire an ILC chartered in one of a handful of States without Federal supervision of the parent holding company and without any restriction on the scope of activities conducted by the bank's affiliates.

At the time the special exception for ILCs was adopted in 1987, ILCs were mostly small, locally owned institutions that had only limited deposit taking and lending powers under State law. Today, however, this exception has become the means through which large commercial and other firms may acquire an insured bank and gain access to the Federal safety net.

Indeed, the changes that have occurred with ILCs in recent years have been dramatic. For example, while the largest ILC in 1987 had assets of less than $400 million, the largest ILC today has assets of more than $60 billion and is among the 20 largest insured banks in the United States.

The exception also is open-ended and subject to very few statutory restrictions. There is no limit on the number of ILCs that the grandfathered States may charter going forward, and Federal law allows ILCs to engage in virtually the full range of deposit taking, lending, and payment-related activities.

The Board is concerned that the recent and potential future growth of ILCs threatens to undermine the decisions that Congress has made concerning the separation of banking and commerce and the proper supervisory framework at the Federal level for companies that own a federally insured bank. For many years, Congress has sought to maintain the general separation of banking and commerce. Congress reaffirmed this policy in the Gramm-Leach-Bliley Act of 1999, when it closed the unitary thrift loophole, which previously allowed commercial firms to acquire a federally insured savings association.

As you know, the Gramm-Leach-Bliley Act allows financial holding companies to engage in full-service securities, insurance, and merchant banking activities. Yet Congress allowed only broader financial affiliations and allowed these financial affiliations, which is a lesser step than allowing commercial affiliations, only for companies that ensure that all of their subsidiary depository institutions remain well capitalized and well managed and maintain at least a satisfactory CRA rating.

The ILC exception undermines each of these decisions. It allows insured ILCs to affiliate with commercial firms, not just financial firms, as provided in the Gramm-Leach-Bliley Act. Moreover, it does not impose anything comparable to the strong capital, managerial, and CRA requirements that Congress established for financial holding companies in the Gramm-Leach-Bliley Act.

The ILC exception also undermines the supervisory framework that Congress established for the corporate owners of insured banks. Although ILCs themselves are fully and capably supervised by both State and Federal banking authorities in the same manner as other commercial banks, the parent company of an ILC may not be. This creates a supervisory blind spot because the supervisory authority over bank holding companies and their non-bank subsidiaries under the BHC Act is significantly broader than the supervisory authority that the primary Federal supervisor of an ILC has with respect to the corporate owner and affiliates of an ILC.

In 1991, Congress also made consolidated supervision a prerequisite for foreign banks seeking to acquire a bank in the United States. The ILC exception, however, allows a foreign bank that is not subject to consolidated supervision in its home country to evade this requirement and acquire an insured bank in the United States.

The Board applauds the Committee for holding this hearing. The ILC exception is reshaping the Nation's policies on banking and commerce and the supervisory framework for the corporate owners of insured banks. The Board believes that the decisions on these important policies which influence the structure and resiliency of our financial system and economy should not be decided by a few companies through the exploitation of an exception, but should be decided by Congress, which can act in the Nation's best interest.

I would be happy to answer any questions.

Senator BROWN. Thank you, Mr. Alvarez.
Mr. Bovenzi.

STATEMENT OF JOHN BOVENZI, CHIEF OPERATING OFFICER AND DEPUTY TO THE CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. BOVENZI. Senator Brown, Members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation concerning industrial loan companies.

The FDIC strongly supports efforts to provide statutory guidance on the key issues regarding the ILC Charter, especially the issue of commercial ownership. Many of the issues surrounding the ILC Charter involve important public policy that are best left to Congress for resolution. This hearing and proposals for possible legislative solutions are encouraging developments that hopefully will lead to the resolution of key ILC-related issues by the end of the year.

ILCs have proven to be a strong, responsible part of our Nation's banking system. Many ILCs have made significant contributions to community reinvestment and development. Other ILCs serve customers who have not traditionally been served by other types of financial institutions. Overall, the ILC industry has operated in a safe and sound manner, and the FDIC has been a vigilant, responsible supervisor of that industry.

ILCs represent a very small part of the overall banking industry, composing less than 1 percent of the approximately 8,600 insured depository institutions in this country and only 1.8 percent of assets. Of the 59 existing ILCs, 44 are either widely held or controlled by a parent company whose business is primarily financial in nature. These ILCs represent approximately 84 percent of ILC assets and 87 percent of ILC deposits. The remaining 15 ILCs are associated with parent companies that may be considered non-financial.

There has been significant growth in the ILC industry in recent years, with most of that growth occurring since 1996 and concentrated in a few number of these firms. In addition to the growth in the ILC industry, the character of ILCs has been changing. In the current business environment, many ILCs tend to be more complex and differ substantially from their original consumer lending focus. In some circumstances, consolidated supervision may not be present and the current supervisory infrastructure may not provide sufficient safeguards to address safety and soundness risks to the Deposit Insurance Fund.

To address these developing concerns, the FDIC has taken a number of actions regarding ILCs in the past year. In July 2006, the FDIC Board of Directors adopted a 6-month moratorium on all applications for deposit insurance and changing controls for ILCs. The moratorium allowed the FDIC to evaluate public and industry comments, assess developments in the industry, and consider how best to apply the Corporation's statutory powers for oversight of these charters.

It is clear that the most significant concern regarding ILCs is their ownership by companies engaged in nonfinancial activities. Based on this analysis, the FDIC Board voted to extend the mora-

torium through January 2008. Under the extended moratorium, the FDIC will not take any action on an application for deposit insurance or changing control for a company that would be controlled primarily by one engaged in commercial activities. The moratorium extension does not apply to ILCs that would be controlled by a company engaged only in financial activities or that would not be part of a holding company structure.

In addition to providing the FDIC with time to examine the appropriate supervisory structure for the changing ILC industry, extending the moratorium provides additional time for Congress to consider legislation, although the FDIC is not endorsing any particular legislative approach.

In closing, ILCs have a good safety and soundness track record to date. They have proven to be a strong and responsible part of our Nation's banking system, yet the types and number of ILC applications have evolved over the years. These changes pose potential risks that deserve further study and raise important public policy issues. The FDIC has the responsibility to consider applications under existing statutory criteria and make decisions. While it is appropriate to proceed cautiously, the FDIC cannot defer action on these matters indefinitely.

The current statutory exemption providing for the ILC Charter is quite broad. By providing clear parameters to the scope of the charter, Congress can eliminate much of the uncertainty and controversy surrounding it. Resolving these issues will enhance the value of the ILC Charter going forward. The FDIC looks forward to working with Congress in the coming months as you work to bring these matters to closure.

This concludes my statement. I will be happy to answer any questions that the Committee might have. Thank you.

Senator BROWN. Thank you, Mr. Bovenzi.

Mr. Polakoff.

STATEMENT OF SCOTT M. POLAKOFF, SENIOR DEPUTY DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. POLAKOFF. Good morning, Mr. Chairman and Members of the Committee. Thank you for the opportunity to present the views of the OTS on activities, ownership, and control of ILCs. There are three points that I would like to present to you today.

No. 1, the OTS as primary Federal regulator supervises eight savings and loan holding companies whose subsidiary ILCs control more than 55 percent of assets in the ILC industry.

No. 2, the OTS supervises 17 commercial savings and loan holding companies that were grandfathered with the enactment of Gramm-Leach-Bliley. These 17 commercial firms own thrifts with total assets in excess of $40 billion. Our effective supervision ensures that risks from the commercial operations do not impact the insured financial institution.

And, No. 3, the OTS in its role as the primary Federal regulator for savings and loan holding companies that own ILCs has an excellent working relationship with the FDIC and the relevant State banking commissioners.

Congress gave the OTS the responsibility to supervise savings and loan holding companies through the Homeowners Loan Act.

Congress confirmed that authority in 1999 with the Gramm-Leach-Bliley Act. OTS currently supervises savings and loan holding companies that control more than 55 percent of the ILC industry assets. These holding companies, which own thrifts and are, therefore, statutorily regulated by OTS, include Merrill Lynch & Company, Morgan Stanley, American Express Company, USAA, Lehman Brothers Holdings, General Electric, Beal Financial, and General Motors Corporation.

The ILC debate raises a number of important issues with respect to key areas of permissible activities and oversight of companies that own or seek to acquire an ILC. Chief among these are affiliate risks, including risks from commercial activities that could impact the insured financial institution.

As you know, Gramm-Leach-Bliley grandfathered a number of commercial firms within the unitary thrift holding company. Currently, the OTS regulates 17 commercial firms that own thrift institutions, and we have a sound improvement oversight program that addresses potential risks arising from commercial activities. In addition to several of the companies I just mentioned, the commercial entities that we supervise include Temple Inland Corporation, Archer-Daniels-Midland, John Deere Corporation, Nordstrom, and Federated Department Stores.

In exercising our statutory authority of savings and loan holding companies, we work cooperatively with other regulators, including Federal and State banking agencies, functional regulators, including State insurance supervisors, and Federal and State securities supervisors. We also coordinate with international financial supervisors on the oversight of the internationally active savings and loan holding companies and their affiliates and subsidiaries. In fact, our supervisory program is internationally recognized by foreign regulators, including the U.K.'s Financial Services Authority, or FSA, and France's Commission Bancaire, and has achieved equivalency status from the EU for three firms: General Electric Company, AIG, and Ameriprise Financial Group.

We are also recognized by Federal statute as one of the two U.S. regulators authorized to make a determination as to whether a foreign bank entering the U.S. is subject to comprehensive consolidated supervision for purposes of coordinating consolidated supervision of its domestic banking activities.

The OTS' status as a consolidated U.S. supervisor requires extensive contact with the domestic and international supervisory community for these and other internationally active complex firms supervised by the OTS. I would also note that the GAO has confirmed that the OTS has a strong and internationally recognized consolidated holding company supervision regime.

In sum, the OTS has extensive experience overseeing savings and loan holding companies, including financial conglomerates and commercial holding company structures. OTS supervision provides a strong and robust regulatory framework that oversees a holding company's risk management platform. This approach ensures the flexibility these firms require to compete in the dynamic marketplace while providing a strong supervisory structure over their policies, procedures, and activities.

We support the Committee efforts to address concerns with respect to the oversight of ILC holding company parents, recognizing that the OTS currently exercises effective supervision of savings and loans holding companies that control more than half of the ILC industry assets.

In considering possible ILC legislation, we urge the Committee to preserve existing OTS authority and oversight of savings and loan holding companies that own or control ILCs. This will promote functional regulation while also promoting consolidated regulatory oversight of these companies.

Thank you, Mr. Chairman. I look forward to answering your questions.

Senator BROWN. Thank you, Mr. Polakoff.

Mr. Sirri.

STATEMENT OF ERIK SIRRI, DIRECTOR, DIVISION OF MARKET REGULATION, SECURITIES AND EXCHANGE COMMISSION

Mr. SIRRI. Chairman Brown, Senator Bennett, and Members of the Committee, I am pleased to be here today to talk about the SEC's program for supervising U.S. securities firms on a consolidated basis.

The Commission currently supervises five of the major U.S. securities firms on a consolidated, or group-wide, basis. For such firms, referred to CSEs, consolidated supervised entities, the Commission oversees not only the U.S.-registered broker-dealer, but also the holding company and all affiliates on a consolidated basis. These affiliates include other regulated entities, such as foreign-registered broker-dealers, banks, as well as unregulated entities such as derivatives dealers. Four of these CSEs—Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley—own ILCs that account for 1 percent, 0.6 percent, 7.2 percent, and 1.2 percent of their consolidated assets, respectively. Three of these firms—Lehman Brothers, Merrill Lynch, and Morgan Stanley—also own thrifts that account for 3.3 percent, 1.7 percent, and less than one one-hundredth of 1 percent of their consolidated assets, respectively.

I would like to provide some historical perspective on the Commission's oversight of these holding companies.

Over the past 20 years, as broker-dealers have affiliated with more and more complex holding company structures, the Commission has become increasingly concerned about the risk that a broker-dealer may fail due to the insolvency of its holding company or one of its affiliates. This risk was exemplified by the bankruptcy of the Drexel Burnham and the consequent liquidation of its broker-dealer affiliate in 1990. Post-Drexel, the Commission undertook a number of initiatives to conduct group-wide risk assessments of financial institutions with significant broker-dealer subsidiaries. These initiatives assisted the Commission in understanding how financial institutions with larger broker-dealer subsidiaries managed risk globally at the group-wide level and over time have allowed the Commission to develop the capacity to supervise holding companies of securities firms.

The Commission's concern regarding the need for group-wide risk monitoring paralleled the European Union's Financial Conglom-

erates Directive, which essentially requires non-EU financial institutions doing business in Europe to be supervised on a consolidated basis. In response, the Commission in 2004 crafted a new comprehensive consolidated supervision program that was intended to protect all regulated entities within a group, including the broker-dealers. The rule restricted CSE eligibility to groups with large, well-capitalized broker-dealers. In other words, the Commission believed that it should only supervise on a consolidated basis those firms engaged primarily in the securities business, and not holding companies that are affiliated with a broker-dealer as an incident to their primary business activities. To this end, the rule effectively requires that the principal broker-dealer have tentative net capital of $5 billion.

The CSE program has five principal components: First, CSE holding companies are required to maintain and document a system of internal controls that must be approved by the Commission at the time of initial application. Second, before approval and on an ongoing basis, the Commission examines the implementation of these controls. Third, CSEs are also monitored continuously for financial and operational weakness that might put the regulated entities at risk within the group or put the broader financial system at risk. Fourth, CSEs are required to compute a capital adequacy measure at the holding company that is consistent with the Basel Standard. And, finally, CSEs are required to maintain significant pools of liquidity at the holding company level, where these are available for use in any regulated or unregulated entity within the group without regulatory restriction.

These five principal program components are implemented in conjunction with the authority to protect regulated entities within the groups. When potential weaknesses are identified, the Commission has broad discretion under our rules to respond. For example, The Commission has broad discretion to mandate changes to a firm's risk management policies and procedures, effectively requiring an increase in the amount of regulatory capital maintained at the holding company, or requiring an expansion of the pool of highly liquid assets held at the parent. The powers are not theoretical. All three of these steps have been taken over the years at various CSEs.

The program of consolidated supervision that I have described reduces the likelihood that a weakness at the holding company or at an unregulated affiliate will place a regulated entity, including an ILC, or the broader financial system, at risk. My written testimony describes in more detail the means by which we monitor on an ongoing basis the financial and operational condition of the CSEs.

In conclusion, while we generally support the goals of consolidated supervision of holding companies affiliated with industrial loan companies, any legislation should ensure that CSEs, which are highly regulated under the Commission's consolidated supervision program, are not subjected to an additional layer of duplicative and burdensome holding company oversight. Any legislation should recognize the unique ability of the Commission to comprehensively supervise the consolidated groups that are overwhelmingly in the securities business, especially given the heightened focus these days on the issue of global competitiveness. And

any legislation should carefully respect the deference accorded by Gramm-Leach-Bliley to functional regulators in overseeing the activities of functionally regulated members of financial holding companies.

I would be happy to take any questions. Thank you.

Senator BROWN. Thank you, Mr. Sirri.

Mr. Leary.

STATEMENT OF EDWARD LEARY, COMMISSIONER, STATE OF UTAH DEPARTMENT OF FINANCIAL INSTITUTIONS

Mr. LEARY. Good morning, Chairman Brown, Members of the Committee. Thank you for the opportunity to share Utah's view on supervision and regulation of industrial banks.

Since the founding of this Nation, States have chartered, regulated, and supervised banking. The choice of charter remains a critical component of the checks and balances of the dual banking system. It is, therefore, vital that there is more than one approach to the regulation and supervision of financial institutions.

Dual banking has built upon the ability to freely choose the supervisory structure under which the ensured entity operates. This foundation contributes to a competition excellence among the financial regulators.

I was invited to participate in this hearing today because of Utah's history and experience in chartering regulated industrial banks. My view and statement is that industrial banks are the embodiment of what is right and proper in the dual banking system.

Utah believes there is good supervision and a good regulatory model over the industrial banks. Without a question of the competency of the regulators and that there has not been a single Utah industrial bank failure warranting a change in public policy, there is no safety and soundness crisis evident that warrants restricting or restraining State-chartered industrial banking.

I believe that I am here today because of the success of the Utah regulatory model, not its failure. Utah, in partnership with the FDIC, has built a regulatory model to which the financial services markets have reacted favorably. This regulatory model is not a system of lax supervision and inadequate enforcement. Utah industrial banks are safe, sound, and appropriately regulated by both the States which charters them and the FDIC, which is the relevant Federal regulator and deposit insurance provider.

Industrial banks are subject to the same banking laws and are regulated in the same manner as all other FDIC-insured depository institutions, including the Community Reinvestment Act. However, special emphasis has taken on the Federal Reserve Regulation W and Sections 23A and B of that regulation, which closely regulates all parent and affiliate company transactions to ensure that there is a limit to covered transactions and an arm's length basis for all transactions. Thus, an industrial bank may not extend significant amounts of credit to its holding company or affiliate or offer credit to them on preferential or non-market terms.

The department takes this supervisory role seriously. It is a joint effort with the FDIC in all industrial bank examinations and targeted reviews. Our examiners are participating in large loan, capital market, trust, information system, consumer compliance, Com-

munity Reinvestment Act, Bank Secrecy Act, anti-money-laundering examinations.

The supervisory model of the industrial bank has been referred to as a "bank-centric" model. This is not a new concept when examining a bank as part of a holding company structure. Industrial banks based in Utah have represented a laboratory 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 and insure a depository institution from potential abuses and conflicts of interest. Critical controls have been developed of this cooperation between Utah and the FDIC.

In the industrial bank model, the bank is insulated and isolated from the potential negative effects of a parent company by existing Federal banking laws. However, in addition, we require the bank to maintain its own separate capital, independent management, and a requirement that the board of directors consists of a majority outside independent directors.

I think one could argue that having more banks in the market would help supply much needed liquidity into the market, and having a diversified parent company not solely dependent on banking would be able to provide such needed liquidity. Having more liquidity, more competition, more diversification of insured deposits, less concentration by large banking corporations is good for the market, for the FDIC, and ultimately for the U.S. consumer.

Worst case has been postulated that a financial institution holding company would file bankruptcy or get into financial difficulty. While the reality is we have had both of those occur in Utah, and while no regulator relishes stressful circumstances, I can state that we successfully weathered the storm.

In this final point, I think we need to keep in perspective that the entire industrial loan industry, even with its growth during the last 20 years, represents only 1.8 percent of banking assets. Utah law establishes, besides all other jurisdiction and enforcement authorities over industrial banks, that every industrial bank holding company must register with the department and is subject to the same jurisdiction and enforcement authority as the bank. Utah commenced last year a program where every holding company will receive an inspection at least every 3 years, coupled with ongoing offsite monitoring of rating agencies, analyst opinions, and market sources. Where there is a Federal agency involved, we attempt to offer resources and share work product.

Thank you for allowing me the opportunity to express my thoughts and your willingness to listen to a State regulator.

Senator BROWN. Thank you very much, Mr. Leary, for joining us.

Mr. Alvarez, you spoke in your testimony of a supervisory blind spot. Would you expand on that?

Mr. ALVAREZ. Certainly. Owners of banks are required to be supervised under the Bank Holding Company Act by a Federal regulator, the Federal Reserve. Owners of savings associates are required to be supervised by the OTS. Owners of ILCs, however, are not required to be supervised by anyone. There is no one with authority to supervise an owner of an ILC based on their ownership of the ILC.

That is the trend going forward. ILC growth has been by companies that do not own a savings association or a bank or are not part of the SEC's CSE program. So the recent applications that the FDIC has been charged with dealing with largely involve institutions that—corporate owners that will not be supervised by anyone unless there is a change in the law.

Senator BROWN. Mr. Bovenzi, suppose there is an application for an ILC that is limited, serving a niche market of some sort. If the application is approved, are the limitations forever part of that charter?

Mr. BOVENZI. Not necessarily. What would happen with an application is someone would come forward with a business plan; we would look at it and determine its appropriateness, whether it was meeting the statutory criteria to give it approval. If it did, it would receive approval. There would be nothing that would stop that applicant, once approved, to come back and request a change in their business plan at a later date, and then that would be evaluated at that point.

Senator BROWN. Is that troubling to any of you as regulators, his answer to that? Mr. Polakoff?

Mr. POLAKOFF. Senator, I would offer that the examiners do a great job of examining all insured financial institutions and understanding the risk profile of those institutions, and through a prudential examination program, I believe the examiners are able to measure the risk profile versus a constantly changing business strategy and assess the risk properly.

Senator BROWN. OK. You were going to say something?

Mr. ALVAREZ. The one concern I would have on the change in conditions of charter is that it does mean that the situation could develop over time and that conditions that initially are imposed in order to hold still a system may not be able to withstand the passage of time. If things do not develop that are troubling, then the conditions often are removed over time.

So it is difficult to—it is not wise, I think, to develop a policy based on the thought that conditions will not change over time.

Senator BROWN. Mr. Alvarez, in a slightly different direction, I think the Federal regulators on the panel pretty clearly agree that consolidated supervision is a good idea, provided there is not duplication. Explain to me why this is important. And do you have any examples of why simply looking at a bank is not sufficient?

Mr. ALVAREZ. Yes. Looking at a bank is certainly a necessary element of proper supervision. On the other hand, a holding company can serve as a source of weakness to the Bank, and there are examples in the ILC context. A small ILC in California that was owned by a holding company that was engaged itself in very risky activities had incurred significant leverage at the holding company, was not able to access the markets to get additional capital when its ILC ran into trouble, and was not able to provide managerial or other financial strengths to the ILC when the ILC was in trouble. The ILC then failed.

The job of a supervisor of a holding company is to make sure that a holding company does not serve as that kind of source of weakness to identify risks at the holding company that could be transmitted to the bank or that other things that could be an impedi-

ment to holding company serving as a source of strength to the bank.

Senator BROWN. Thank you.

Senator Bennett.

Senator BENNETT. Thank you very much.

Mr. Alvarez, I hope I am not mischaracterizing, but I got a little sense out of your prepared testimony that the sky is falling and we have to act really quickly or we will be hit with great chunks of crystallized cloud and other problems coming from above. I wonder how that is possible when we are talking about, as pointed out, less than 1 percent of the Nation's financial institutions and 1.8 percent of the total assets and a history of no failures. You answers used words like "could" and "may possibly" and things of that kind, but dealing with the actual reality of the marketplace here, I do not see a solid case for changing the regulatory regime.

On March 19, 1997, Alan Greenspan said the following in testimony to the Capital Markets Subcommittee: "The case is weak, in our judgment, for umbrella supervision of a holding company in which the bank is not the dominant unit and is not large enough to induce systemic problems should it fail."

Now, obviously, we talk about things have changed and the attitude of the Fed has changed since Chairman Greenspan made that statement.

What event caused the Fed to change its mind from Greenspan's position?

Mr. ALVAREZ. Senator, I think there are a couple of things. First of all, the Fed believes—and I think the Senate has asked us to identify issues before they become a crisis and before they become a problem as we see them developing. Since the Gramm-Leach-Bliley Act in 1999 that closed the unitary thrift loophole, there has been a significant increase in the amount of applications to acquire industrial loan companies by commercial entities. And it has become quite clear that this is now the avenue of choice for undermining the decisions Congress made in banking and commerce and regarding the supervisory framework.

So I am not here to tell you that disaster has already occurred. I am here to tell you that things are changing in a dramatic way that we think will not be easy to unwind. It will be very difficult once a significant number of institutions have acquired—a significant number of institutions have acquired ILCs, to roll back that clock. It will be very difficult to change the supervisory framework when there is a large group that owns ILCs outside of that statutory framework.

Senator BENNETT. You say that these applications have been undermining the decisions of Congress, and I repeat to you, as I said in my opening statement, the man who had the most to do with writing the decisions of Congress does not agree with you. Senator Gramm believes that the activities with respect to ILC were precisely what they had in mind when they passed Gramm-Leach-Bliley.

I would like to focus for just a minute on the consumer. The whole purpose of an ILC is to serve an underserved area in the consumer world. If there is an area in the consumer world that is currently being served, there is no market opportunity for an ILC

to get in there unless there is some kind of improper advantage, and no one has suggested that that improper advantage exists.

But the track record of ILCs is that the consumers have benefited over a wide range of the economy in relative small niche after niche after niche where the ILC, by virtue of its understanding of that niche, has gone after that opportunity and provided financial services to a consumer or a group of consumers that did not have those services available to it in a convenient way before that.

I am concerned that if we clamp down in the way that you are talking about from an overall regulatory standpoint in Washington, there is going to be a concomitant diminution of consumer services available out in the country as a whole.

I would appreciate your comments about that, any of you.

Mr. ALVAREZ. Senator, if I might respond, I think that to the extent that we believe the ILC is helpful to consumers because it allows banks to be affiliated with commercial firms, then perhaps we should consider the broader issue of banking and commerce and whether Congress should change that framework for everyone. Right now, 99 percent of the owners of banks are prohibited from being involved in commercial activities at all. You suggest that consumers are benefited by the fact that ILCs are allowed to mix banking and commerce. If that is really a benefit to consumers, then Congress should consider how to allow more people to take advantage of that and allow consumers to better be served by that combination and all of the kinds of protections that Congress thinks might be appropriate in assuring that the dangers of mixing banking and commerce also do not get passed on to the taxpayer, but that the consumer is able to benefit.

So we think that there is a level playing field here that should be addressed as well, and consumers could either benefit or be hurt in both directions.

Senator BENNETT. Senator Gramm felt it was going in the other direction.

Thank you, Mr. Chairman.

Senator BROWN. Thank you.

Senator Reed.

Senator REED. Thank you, Mr. Chairman. I just want to follow up and try to define, in my mind at least, this regulatory blind spot.

With Mr. Bovenzi, Mr. Polakoff, and Mr. Sirri, there is a combination of SEC, OTS, and FDIC supervision of the ILC and the parent in certain cases. But is there a category of arrangements where there is no supervision of the parent whatsoever? Mr. Alvarez.

Mr. ALVAREZ. Yes, Senator, there are. The universe of companies that own a savings association is fixed. The CSE, the group that the SEC supervises, is not fixed by statute but is rather small. And there are several, actually, owners of ILCs that are bank holding companies supervised by the Federal Reserve.

But when you take those fixed universes out, there is a large group of corporate owners of industrial loan companies that are supervised by no one, and that is the group that is growing over time. That is the group that wants to affiliate with ILCs now.

Senator REED. So that is the potential that you are anticipating, a company that would not be subject to SEC at the holding company level.

Mr. ALVAREZ. Correct.

Senator REED. At the parent level, OTS or FDIC, they have now sort of an open range, if you will, to acquire or create ILCs, and unless they agree, some type of voluntary supervision to say you do not supervise me.

Mr. ALVAREZ. That is correct.

Senator REED. And that potential, if there is no boundary, is extremely large.

Mr. ALVAREZ. It is. It includes all commercial companies as well as financial companies.

Senator REED. Let me ask another question which is reflective of some of the comments you made. Are there any ILCs owned by foreign entities today?

Mr. ALVAREZ. There is one that is owned by a foreign bank, but a foreign bank that is supervised by the Federal Reserve.

Senator REED. If there was an acquisition by a foreign entity, Airbus or someone who wanted to buy it, would that trigger some type of change in control application or could they simply set it up, fund it, and there is no way you could turn them down because of the nature of their activities? Is that the latter case?

Mr. ALVAREZ. That would be subject to a change in control act notice before the FDIC. That is the subject of the FDIC's moratorium at this point, which is due to expire in January.

Senator REED. OK. With respect to your role, Mr. Leary, which is very critical in Utah, do you have statutory authority to supervise the parent of the ILC?

Mr. LEARY. Yes, sir. That was my final point. We do have that authority. It has never been challenged. What we had not done effectively until more recently was attempt—or establish a regulatory program where we go into those holding companies. And the universe we are talking about is really about ten companies where there is no Federal oversight at this current point in time.

Senator REED. Do you have the capacity to do that?

Mr. LEARY. Yes.

Senator REED. Without being less than respectful, because, you know, one of the issues at the State government level is that, you know, sophisticated—the capacity to do that, the number of examiners you have, the ability to send them to Paris to look at the books of the companies sometimes is limited. I speak from experience back in my own home State.

Mr. LEARY. I will tell you, with respect to the domestic side of it, our examiners are going all around the country now to look at the operations of our industrial banks. I am fortunate in that the industry has been very supportive of—they want quality regulation. It is not in their best interest or ours not to have that. So they have supported the structure that establishes sound regulatory agency.

Senator REED. Do you have a potential problem, at least, as a Utah examiner goes into an ILC that has a presence in Missouri, for example, frankly, you know, is there a problem just of enforcing your—I guess you get the holding——

Mr. LEARY. We have the holding company of the bank headquartered and chartered in Utah; therefore, we go into it. So my statement is we have gone around, we are going around in large numbers looking at the operations of——

Senator REED. All right. You said you had an independent board. Is that independent of the holding company or of the bank?

Mr. LEARY. Of the holding company.

Senator REED. So that they would have to have—the majority of the members could not have any direct affiliation with the holding company.

Mr. LEARY. Absolutely.

Senator REED. OK. And what type of powers do you have? Could you compel the holding company to put more capital into the——

Mr. LEARY. Yes.

Senator REED. OK. Have you ever tried to do that?

Mr. LEARY. Have not.

Senator REED. Again, I just think that Mr. Alvarez has pointed out a situation where this could be exploited dramatically by folks coming in, taxing the capacity of any one States to be effective regulators. Also, on another point—and my time is running out—which you might get to if you can weave it into other questions and responses, is the comparative advantage that these institutions have versus a fully regulated financial entity in the United States, someone subject to Bank Holding Company, FDIC, et cetera, or OTS supervision.

Thank you.

Senator BROWN. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Mr. Bovenzi, last year the FDIC—you talked about the moratorium that is set to expire in January. Will you allow it to expire?

Mr. BOVENZI. The moratorium will automatically expire at the end of January, and our Chairman——

Senator BUNNING. But you set it, so you have the opportunity to extend it or not to.

Mr. BOVENZI. That is correct. Our Board of Directors could make that decision. Our Chairman stated that we do not expect to extend it beyond the end of January.

Senator BUNNING. OK. What information do you not have access to that is needed to assess safety and soundness?

Mr. BOVENZI. The authority that we have largely relates to the individual insured institution. We have a full range of authority there. To the extent that it involved relationships with affiliates of that insured institution, we have the authority to examine—if we feel that the affiliate is having some effect on the financial condition of the insured institution, we have examination authority under those circumstances. We have enforcement authority as well. So we use that authority to gather information from affiliates and holding companies to help assess implications for the insured institution.

Senator BUNNING. Then you are telling me that you do not have any problems?

Mr. BOVENZI. I can tell you our history to date is that has worked well for us.

Senator BUNNING. This is for anyone. Why are you not worried about commercial enterprises owning finance companies as you are about them owning banks? Can lenders not cause as much damage to our financial system as banks? Anyone.

Mr. ALVAREZ. Senator, one of the differences between ownership of a financial company, say a lending company, and ownership of a bank is that the bank collects deposits that are insured by the FDIC and backed by the taxpayer. It is because of that obligation of the taxpayer that the Federal Government has traditionally insisted on supervisory authority over the insured bank itself and the owner of the insured bank.

Senator BUNNING. Mr. Leary, in your examination of industrial banks owned by commercial enterprises, have you found any evidence that they are more likely to fail than banks owned by regulated holding companies?

Mr. LEARY. My answer would be no, we have not found there is a preponderance for them to fail. The holding company business plans may change, but what we have attempted to do is cocoon and isolate that insured bank, it has its own deposit, it has its own board of directors, it has its own management. And the example I tried to use is we have had two examples where parents have had trouble, but those banks continued and remained either in operation or somebody else came in and bought it and established it as a bank.

The true thrust, I think, of your question, Senator, is under a banking umbrella—and, believe me, it is in the State's best interest to get these institutions under a strong banking umbrella—the standards are higher, the quality of performance demanded of management is higher, and I think the country is well served when they are under this higher standard of banking. And that is specifically applied to those that may be owned by commercial entities not currently supervised by Federal agencies.

Senator BUNNING. This is for anyone. Do you have any evidence that industrial banks owned by commercial enterprises have endangered other regulated institutions?

Mr. BOVENZI. No.

Senator BUNNING. Anybody else?

Mr. POLAKOFF. No, sir.

Mr. LEARY. No.

Senator BUNNING. If Congress enacts new regulations of industrial banks, is there any reason not to allow banks chartered in any State to get deposit insurance?

Mr. LEARY. I would volunteer the answer from the Utah perspective. I have been asked if the model in Utah works well, would we support other States? While I would not support other States, I have absolutely no problem with other States being able to take advantage of the model——

Senator BUNNING. What about the Fed?

Mr. ALVAREZ. Sir, if you believe that industrial loan companies offer an advantage and that the policy of the United States should be that there would be a mixing of banking and commerce, then we believe it should be done on a level playing field with all folks being——

Senator BUNNING. Regulated?

Mr. ALVAREZ [continuing]. Able to take care of this and all in the same framework.

Senator BUNNING. OK. Thank you very much, Mr. Chairman.

Senator BROWN. Thank you, Senator Bunning.

Senator Allard.

Senator ALLARD. Mr. Chairman, I apologize for missing the opening statements.

Senator BROWN. Proceed.

Senator ALLARD. I come from a State that had industrial bank failures, and I served in the legislature at the time that happened, and it was not a pleasant experience. We obviously were not following the Utah model in Colorado at the time. What it ended up being is that the State of Colorado ended up mitigating damages to the depositors in the banks by sharing in the cost of those lost dollars, and even despite that, those depositors did lose money.

You know, I gather from your discussion here that you are mainly concerned about the potential risk to the Federal Insurance Corporation. Is that right?

Mr. ALVAREZ. That is right.

Senator ALLARD. I guess one of the things that we are struggling with in this particular piece of legislation working with the Chairman is what is the proper threshold of where you consider non-financial services when you make the definition. We have in the legislation 15 percent. I understand that there might be members on this panel that think that should be lower, and I would like to get some discussion on that. I think it would be beneficial.

I think when we looked at it, we looked at it from a practical aspect and that sometimes a bank, if they are expanding, they will take a building that is larger than what they need, and they will lease out that building—or maybe it is just part of diversifying the use of that building. They will lease it out, and it could easily exceed 15 percent—well, I should not say "easily." They could. But we thought that 15 percent was sort of a reasonable balance in that, and I would like to hear some comment from the panel members if you would, please.

Mr. ALVAREZ. Well, Senator, this is an issue that was debated in the Gramm-Leach-Bliley Act. You may recall that there were proposals to have a 5-percent commercial basket in Gramm-Leach-Bliley, and after much debate, those proposals were either withdrawn or defeated.

It is hard to figure out exactly the right place to draw the line. The question, though, I think, is that—and I think the concern from the Fed is that Congress should be the one that does draw that line, and we think it would be important to have some hearings on this issue to decide what the costs and benefits of mixing banking and commerce at any level should be, beyond the Gramm-Leach-Bliley Act, to look at the experience in Asian countries and in other countries that have mixed banking and commerce, to try to decide if that is a road we want to go down, and if so, whether to go in stages, as you suggest, 5 or 10 or 15, or to open it up more broadly.

It is a very complicated issue. There are lots of questions about how to prevent the transmission of risk from a commercial entity to a bank. There are lots of questions of how to ensure that banks

that are owned or affiliated with commercial companies are competitive and deal with everyone equally rather than just favoring the commercial entity itself. There are other issues in banking and commerce that deserve exploration, and it is very difficult to say it is safe to pick one basket, one line or another. I think we would welcome a broad debate on the issue.

Senator ALLARD. It is probably best that we have some bright line there, and then people learn to work with it.

Mr. ALVAREZ. But then you would be able to set the line with some understanding of what the costs are with that line.

Senator ALLARD. Right. Any other comments on the panel?

Mr. BOVENZI. Senator, I would just add that we do not have a particular view on where you want to draw that line. We do think this is the most significant public policy issue that is brought up and that Congress should try to draw that line and provide everyone with a workable solution.

Senator ALLARD. Any other comments?

[No response.]

Senator ALLARD. Mr. Alvarez, you talked a little bit about foreign countries that have combined commercial with banking financial institutions.

Mr. ALVAREZ. Yes.

Senator ALLARD. And I am wondering, I assume the panel has maybe looked at this in foreign countries where this happened. Japan is the country that comes to my attention. They combine and intermix extensively, I think, commercial and banking.

Has that worked well in Japan? Or have there been some shortcomings? And would somebody comment on that? I would like to know how that is working.

Mr. ALVAREZ. Well, I am not an expert in the Japanese system, but it has had its advantages and its disadvantages. I think the corporate entities in the broader affiliations have done well during times when they have needed financing. But it certainly was the combination of banking and commerce, and the amount of risk that the depository institutions had taken on from their corporate affiliates that certainly was one of the factors in the problems Japan has encountered recently. It is very complicated. It is only one of many factors, but it was one of the factors in the long period of Japanese doldrums.

Mr. POLAKOFF. Senator, if I could offer——

Senator ALLARD. Yes.

Mr. POLAKOFF. I am certainly not an expert either. The issue may not necessarily be ownership. The issue may be prudential regulation, ensuring that the proper rules are in place, the proper examination procedures are in place. And then I would offer a level playing field amongst all the insured institutions.

Senator ALLARD. I do know that some of our discussion, you know, when we have problems with banks, we take care of it right away. And from what I hear, in Japan it does not get taken care of right away, and I wondered if this had anything to do with that. So thank you for your comments.

Thank you, Mr. Chairman.

Senator BROWN. Thank you, Senator Allard.

Senator Bennett and Senator Reed have asked for an additional 3-minute second round, which we will do. I wanted to clarify—and then Senator Carper certainly has an opportunity. I wanted to clarify Mr. Polakoff's statements about Mr. Alvarez's statement and part response to Senator Allard about the comments of mixing banking and commerce in other countries, so that the shortfall in other countries, in your mind, Mr. Polakoff, is less the question of mixing commerce and banking as it is the lack of a solid regulatory structure?

Mr. POLAKOFF. Looking at it from a domestic perspective, Senator, I would say that the ownership issue is to an examiner not the key point. It is having an effective prudential examination program with the right legislative action all in place to prevent abuses from occurring between the entities.

Senator BROWN. OK. Thank you.

Senator Carper, would you like a round of questions?

Senator CARPER. I would. It will be a short round.

Senator BROWN. OK. Go for it. Thank you.

Senator CARPER. Thank you, Mr. Chairman.

To all of our panelists, welcome today. Thanks for being here and for your testimony and responding to our questions.

I understand that a number of auto companies have affiliated ILCs. Does anybody know which ones?

Mr. LEARY. Senator, I have the list here, if you would like it, at least with respect to Utah. The FDIC might be better served to have the list for all of them.

Senator CARPER. OK.

Mr. LEARY. BMW, Volkswagen—which is in the process of liquidating their bank at this point in time.

Senator CARPER. Any idea why?

Mr. LEARY. Excuse me?

Senator CARPER. Any idea why?

Mr. LEARY. Change of ownership at the ultimate holding company would require additional application, which would be caught in the current moratorium that is going on.

Senator CARPER. OK.

Mr. LEARY. Simply an existing owner of Volkswagen desiring to increase its ownership level.

With respect also to GM, GM has one—GMAC. And then we have two—when I say "we," Utah has two applications that we have—one received and approved, one that has been delivered from Chrysler and Ford.

Senator CARPER. You say one that has been received and approved?

Mr. LEARY. The Chrysler application has been received and approved at the State level, not at the FDIC level.

Senator CARPER. OK. And did you mention Ford?

Mr. LEARY. The Ford application has been—we have received it. We have not accepted it as complete yet because of the moratorium.

Senator CARPER. Thank you.

Are there any others that were not included in that list? Is that everybody?

Mr. LEARY. In Nevada, there is Toyota, I am well aware of it, and also not specifically auto but Harley Davidson.

Senator CARPER. OK. Are there any regulatory concerns that you all have with auto company ILCs? Either a yes or no.

Mr. BOVENZI. Up to date, everything is operated in a safe and sound manner.

Senator CARPER. OK. Anybody else?

Mr. LEARY. I would respond that the provisions of 23A and B and the firewalls that have been established there seemed adequate to allow for prudential regulation.

Senator CARPER. OK. Good.

All right. Mr. Chairman, I told you it would be a short round, and it was. Thank you.

Senator BROWN. Impressive, Senator Carper. Thank you.

Senator Bennett is recognized for 3 minutes.

Senator BENNETT. Thank you very much, Mr. Chairman. I have just two questions.

One, picking up on the final question that Senator Reed asked when he talked about is there a competitive advantage—or a comparative advantage, I think was the comment he made, and I would like to know, Mr. Leary, would you respond to that? Have you seen a comparative advantage on the part of those commercial entities that own ILCs that are not supervised by the Fed or somebody else to those other ILCs? Do you see a comparative advantage there?

And, second, the question for the OTS, the Utah department regulates 15 institutions that have a commercial owner, a commercial affiliation. OTS regulates literally hundreds of thrifts that have commercial affiliates, and I would like to know what the OTS experience is, whether there is, again, some kind of comparative advantage here.

Those are my two.

Mr. LEARY. Senator, with respect to the non-financially owned ILCs, I have one exception I have to declare so it makes sense. GE, while it is a non-financial parent, has OTS supervision at this current point in time. The other banks that we have that are commercially owned are, for the most part, smaller and I do not think their operations constitute any kind of breach of a competition, ethic, or whatever in that area.

I mentioned two of them being the automobile makers; Target Bank is a very small bank, established simply to provide for a business card for foundations and nonprofits that want to buy product or services at Target.

Mr. POLAKOFF. Senator, in reference to the OTS, I do not believe we have hundreds of entities that have commercial relationships, but of the ones that we do have commercial relationships, the prudential supervision from the savings and loan holding company level and the FSB level and our ability to properly examine the regulator, deal with the functional regulator at the affiliate level causes these institutions to operate in a safe and sound manner.

Senator BENNETT. So you see no particular difference.

Mr. POLAKOFF. From my perspective, within OTS they are all under the OTS umbrella. So from our perspective, we have the ability to examine or to work with the functional regulator.

Senator BENNETT. Good. Thank you.

Senator BROWN. Thank you, Senator Bennett.

Senator Reed is recognized for 3 minutes.

Senator REED. Mr. Leary, a deposit-taking ILC in your town must have FDIC insurance, according to State law?

Mr. LEARY. Yes.

Senator REED. OK. And in other jurisdictions would it be possible—I go back to the Federal regulators. It would be possible to create an ILC charter with or without FDIC insurance. You know, a State could try to seize on this approach, to create an industrial loan company, and then——

Mr. ALVAREZ. There are only a certain number of States, a small number of States that are grandfathered under the Bank Holding Company Act. So if a new State were to charter an ILC——

Senator REED. They would have to Federal authority.

Mr. ALVAREZ. Right.

Senator REED. If there is a conflict between FDIC regulation and Utah regulation of an FDIC-insured institution, does the FDIC trump the State of Utah?

Mr. BOVENZI. Well, we have a working relationship where we work closely together, and to the extent differences arise, we have been able to work them out successfully. But, for the most part, they don't arise.

Senator REED. If they did arise, though, is it clear to you that you could insist upon as an insurer that your policy, what you are——

Mr. BOVENZI. We certainly have the ability to operate independently and go forward with our own actions if we determined that were necessary.

Senator REED. The point I am trying to get at is, you know, again, Mr. Leary's department is very serious, very conscientious, but that is not every State, and there are several other States that are grandfathered, and also it could change with different personalities and different policies. But this area is one that is yet to be tested, I would assume, Mr. Bovenzi, in terms of, you know, what you could effectively do to object to a State policy that you thought was wrong. Is that correct?

Mr. BOVENZI. Well, no. We are the primary—we are the Federal supervisor for ILCs, and we can take actions if we deem that is appropriate.

Senator REED. Excuse me, I do not want to be preemptive, but my time has expired. Just a final point. Your whole basis, I presume, is safety and soundness of the institution and functions that are permissible for a regulated institution. It does not go to the policy issue of whether collectively these organizations make sense in our economy. Is that a fair statement?

Mr. BOVENZI. That is a fair statement, that Congress should determine the appropriate role for ILCs.

Senator REED. So all of your comments today as regulators have been, you know, your focus is safety and soundness and permissible activities. If the activities are permissible and the institution is safe and sound, then you have no authority to say you cannot do that, I do not like that, it represents a trend that we do not approve of. Again, I do not want to put words in your mouth, but is

that a fair summary? Mr. Alvarez, quickly, because I am abusing my time.

Mr. ALVAREZ. Yes, that is, but that is why we are here to point this out to you.

Senator REED. Thank you.

Thank you, Mr. Chairman.

Senator BROWN. Thank you, Senator Reed, and thank you all very much, the whole panel, for joining us. A special thanks, Mr. Leary, for coming from Salt Lake. Thank you.

I want to call up the second panel of witnesses.

Thank you all for joining us.

Edward Yingling has been the President and CEO of the American Bankers Association since 2005, following two decades of work at the ABA, where he was responsible for legislative, legal, regulatory, tax and policy development activities. Prior to joining ABA, Mr. Yingling worked for 12 years as an attorney in private practice in Washington. He graduated from Princeton in 1970 with a degree in politics and earned his law degree in 1973 from Stanford.

Marc Lackritz is President and CEO of the Securities Industry and Financial Markets Association. He has been President of the Securities Industry Association since 1992 and continued in that role through the 2006 merger of the SIA with the Bond Market Association. Previously, he has worked as a partner with the law firm of Wald, Harkrader and Ross. He earned a public policy degree from Princeton and earned degrees from Harvard and Oxford University as a Rhodes Scholar.

Peter Wallison holds the Arthur Burns Chair in Financial Policy Studies as a Fellow at the American Enterprise Institute. He has worked as counsel to both the Ford and Reagan Administrations as General Counsel in the U.S. Treasury Department from 1981 to 1985. Mr. Wallison was a partner in the law firm Gibson, Dunn, and Crutcher in Washington, D.C. prior to joining the AEI. He graduated from Harvard in 1963 and earned a law degree from the same school in 1966.

Arthur Wilmarth is a Professor of Law at GW Law School. He has published numerous articles, coauthored a book on corporate law. He is a member of the International Editorial Board of the Journal of Banking Regulation. Prior to joining the GW faculty in 1986, Professor Wilmarth worked as a partner at the Jones, Day, Reavis & Pogue law firm in Washington, although it is Cleveland-based, I might add. He has had over a decade of experience in private practice. He earned his BA at Yale and law degree at Harvard.

Brigid Kelly is the Director of Politics and Communication at the United Food and Commercial Workers Local 1099 in Cincinnati. She is a Council Member in the suburb of Norwood, near Cincinnati. She graduated from Xavier with a BS in Business Administration.

J.J. Singh is Chairman, President and CEO of United Transportation Alliance. Mr. Singh has also worked for Canada-based Imperial Oil Limited and C.H. Robinson Company in Minneapolis, served as President of T-Chek Systems. Mr. Singh holds a masters degree in chemical engineering from the University of Calgary in

Alberta and a masters degree in business administration and finance from McMaster University in Hamilton, Ontario.

Mr. Yingling, please keep comments to 5 minutes and your entire written statement, of course, will be included in the record. Mr. Yingling.

STATEMENT OF EDWARD YINGLING, PRESIDENT AND CEO, AMERICAN BANKERS ASSOCIATION

Mr. YINGLING. Thank you, Mr. Chairman and members of the Committee. I appreciate the opportunity to present the ABA's views on the regulation of ILCs.

Our country's public policy is really clear on this issue. Over the last 50 years, as you pointed out, Mr. Chairman, Congress has repeatedly curtailed the ability of commercial firms to own banks. Laws to this effect were enacted in 1956, 1970, 1987, and 1999.

In each of these laws, Congressional action was a response to commercial firms taking advantage of statutory provisions to engage in banking. Moreover, in each instance, Congress was consistent. It enacted legislation to preserve the separation between banking and commerce. Today the proposed use of the ILC charter by commercial firms has made it necessary for Congress to act once again to maintain the separation.

I was very involved from the private sector side in 1987 when Congress closed the so-called "non-bank bank" provision, through which some non-financial companies were engaged in banking. At that time, an exception was made for ILCs. Most ILCs were small and the few States that were able to charter ILCs were not promoting the charter. Simply put, it was thought that there was no significant risk that problems caused by mixing banking and commerce would arise at the time the ILC exemption was created. This is not the case today. Aggregate ILC assets now exceed $225 billion, an increase of more than 5,800 percent since the 1987 law.

Recent ILC asset growth is no accident. When Congress acted again in 1999 to cut off the ability of commercial firms to engage in banking, this time through unitary thrifts, commercial firms were forced to look for other means of owning banks. It is no coincidence that ILC assets more than doubled from $44 billion to over $90 billion the year after Gramm-Leach-Bliley was enacted.

We believe Congress should act finally to block the ability to mix banking and commerce. Allowing banks to mix with commercial firms raises a host of issues. Among these is the potential for a conflict of interest, particularly in decisions concerning extensions of credit.

But we think the Congress should consider more broadly what our banking system could look like in the future if large commercial businesses begin to own banks. As you mentioned, Senator Brown, the experience in Japan, where cross-ownership of large banks and commercial firms dominated the economy, offers a test case. In Japan, business relationships were placed ahead of sound banking practices. Preference was given to corporate partners and credit was channeled away from smaller businesses. This meant that more resources were steered to less efficient firms and away from startups or competing businesses that were better positioned to meet economic challenges.

The rigidity of this structure explains, in part, why it took so long for the Japanese economy to recover after its bubble burst in the early 1990s. The intertwined relationships between banking and commercial firms subverted corporate governance and resulted in poor business and financial decisions.

Contrast that to the banking system we have in the U.S. Our mixture of numerous banks of varying sizes provides flexibility and options for customers. Our diverse banking system is vital to the growth of our economy, particularly with respect to new and small businesses. In the long run, if commercial firms are allowed to own banks, our unique system could become highly concentrated and rigid. For very good reasons, Congress has repeatedly and consistently taken steps to maintain the separation between banking and commerce.

We stand ready to work with this Committee and the Congress to enact legislation that would maintain this separation.

Thank you.

Senator BROWN. Thank you, Mr. Yingling.

Mr. Lackritz, welcome.

STATEMENT OF MARC LACKRITZ, PRESIDENT AND CEO, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

Mr. LACKRITZ. Thanks, Mr. Chairman.

First of all, it is a pleasure to be here before you. Let me just begin by congratulating you, Mr. Chairman, on your meteoric rise from your election to the Senate to chairing a full Committee hearing.

Senator BROWN. And the Cleveland Indians won the Central Division, all in my first year in office. Amazing.

Mr. LACKRITZ. You are clearly on a roll, and I hope it continues, particularly since I have an aging mother who still lives in Cleveland.

I appreciate the chance to be here. It is a bit like, to quote my own philosophical mentor, Yogi Berra, deja vu all over again, since this is sort of where I came into the movie back 20 years ago. And the issues were about financial services competition and the line to draw between competition and regulation and which chartered institution should do what. So while it has some familiar ring, we are obviously in a different environment and a different set of challenges, which are obviously serious and important as we look forward.

I appreciate being here because industrial loan banks owned by our members hold the majority of all industrial bank assets in the United States.

Congress passed, just to refer back to the Gramm-Leach-Bliley Act, it passed that act in 1999, really almost—it was intended to allow affiliations between and among securities firms, banks, and insurance companies, combined with functional regulation. This ability to structure their operations optimally within existing law has really been critical to the success of industrial banks and their owners. Many of these companies are among the most advanced, sophisticated, and competent providers of financial services anywhere.

We support the ability of regulated securities firms to continue to own industrial banks, just as they do under existing law. Federally insured industrial banks are subject to State banking supervision, FDIC oversight, and all banking laws governing relevant banking activities. Most importantly, the FDIC has authority to examine the affairs of any affiliate of any depository institution, including its parent company. The FDIC's regulation of industrial banks has proven safe and effective, to quote the FDA in a different context.

Industrial banks do not pose any greater safety and soundness risks than other charter types and should not be subject to additional constraints beyond those imposed on other FDIC-insured institutions.

Securities firms' broker-dealer affiliates are regulated by the SEC, as we heard on the earlier panel. And all the SIFMA member securities firms with industrial bank subsidiaries have elected more comprehensive enterprise-wide regulation by the SEC—the consolidated supervised entities that Mr. Sirri testified about before—acting as a consolidated supervisor. The SEC's jurisdiction does not limit the concurrent authority of the bank regulators in any way. Most of the SIFMA member securities firms that own these banks also own savings institutions and are regulated at the holding company level as savings and loan holding companies by the OTS.

The SEC established its CSE framework back in 2004, in part to allow our major global institutions doing business in the EU to comply with its Financial Conglomerates Directive. That directive requires that non-EU firms doing business in Europe demonstrate that they are subject to a form of consolidated supervision by their home regulator that is equivalent to that required of their European counterparts.

The GAO found, in its report on CSEs, that the Federal Reserve, the OTS, and the SEC were generally meeting criteria for comprehensive consolidated supervision. We completely agree that the CSE regime is both robust and comprehensive. Importantly, the SEC's oversight in the CSE regime, just like the Federal Reserve's oversight of banking holding companies, meets the EU's equivalency standard. In addition, the SEC's consolidated regulation standards closely parallel the Fed standards to assess whether a foreign regulatory regime qualifies as a consolidated regulator for a foreign bank operating in the United States.

We strongly believe that SIFMA members that own industrial banks and are subject to consolidated regulation by the SEC should not be subject to additional holding company oversight. The SEC is recognized worldwide as a consolidated regulator and its regulatory requirements and procedures were carefully designed to comply with all standards for effective consolidated regulation in the United States and abroad. That statute should be recognized in order to ensure that global securities firms are not damaged inadvertently.

Over the last two decades, capital markets and the financial services industry have truly become global, integrated, and interconnected. As capital markets and financial products continue to evolve, so too must our Nation's regulatory structure. We need a

regulatory regime that is capable of keeping pace with rapid globalization, technological transformations, and dynamic market changes. That is why we are working to develop a long-term strategy of seeking to modernize, harmonize and rationalize financial services regulation. We note that the U.S. Treasury and other financial services groups have similar projects underway.

Mr. Chairman, we look forward to working with all the interested parties, the financial market participants, regulators, other trade groups, and legislators to ensure a modern, innovative, and globally responsive regulatory structure.

Thank you very much.

Senator BROWN. Mr. Lackritz, thank you.

Mr. Wilmarth.

STATEMENT OF ARTHUR WILMARTH, JR., PROFESSOR OF LAW, GEORGE WASHINGTON UNIVERSITY LAW SCHOOL

Mr. WILMARTH. Thank you, Chairman Brown, and members of the Committee. I appreciate the opportunity to participate in this important hearing.

My testimony will address three major policy questions relating to acquisitions of ILCs by commercial organizations. First, does that ownership conflict with the general U.S. policy of separating banking and commerce? Second, do commercially owned ILCs present risks to the U.S. financial system and the broader economy that are greater than the risks posed by financial holding companies? Third, does the FDIC have adequate supervisory power to control those risks?

As to the first question, commercial ownership of ILCs does conflict with an established policy of separating banking and commerce. Since our republic's founding, banks have frequently tried to expand their activities into non-financial areas and commercial firms have often attempted to control banks. However, Federal and State legislators have repeatedly sought to separate banks from commercial businesses. They have imposed legal restraints on bank powers, and they prohibited bank affiliations with commercial firms in one of two situations. When one, banks were getting involved in commerce and that threatened their safety and soundness. Or two, commercial firms were acquiring significant numbers of banks.

As has already been stated today, on four occasions since 1956, Congress adopted anti-affiliation laws when it realized that commercial firms were making widespread acquisitions of banks or other FDIC-insured depository institutions. ILCs remain the one significant exception to the general policy that currently prohibits acquisitions of FDIC-insured depository institutions by commercial firms.

As to the second question, ownership of ILCs by large commercial firms does pose significant risks. It is likely to spread the Federal safety net and too big to fail subsidies from the financial sector to the commercial sector of the economy. The ability of commercial owners of ILCs to gain access to low cost FDIC-insured deposits will increase the risk to the deposit insurance fund and will create competitive inequities between commercial firms that do control

ILCs and those that do not. It will put great pressure on those that do not to obtain ILCs in order to compete.

Ownership of a large ILC by a giant commercial firm would place great pressure on Federal regulators to provide financial support if either the ILC or its parent company was threatened with failure. If anyone doubts the importance and potential value of the Federal safety net, just look at what happened when the credit markets cut off credit to subprime lenders. Non-depository lenders who did not have access to the credit markets rapidly went out of business. Northern Rock survived only because the UK authorities gave a deposit guarantee and provided liquidity support. Countrywide, in my view, survived only because it could draw upon funding from its Federal thrift subsidiary in the Federal Home Loan Bank system. That, to me, proves in spades what the Federal safety net means.

These organizations are also subject to important conflicts of interest. As our history has shown, and I pointed out in my testimony, and as the history of other countries, including Japan, South Korea, and Mexico shows, there are grave risks involving preferential transfers of funds between banks and commercial affiliates.

Now you have heard, of course, that legal restrictions on those affiliate and insider transactions exist. However, they have often proven to be unreliable during times of financial stress. Many thrifts and many banks that failed during the 1980's and 1990's were found to have violated restrictions on affiliate transactions and insider transactions. I pointed out Lincoln Savings being one of the most notable of these examples.

Moreover, the Federal regulators themselves may feel compelled to waive these restrictions under times of financial stress. After the 9/11 crisis and during the recent subprime crisis, the Federal Reserve Board granted waivers that allowed major banks to transfer funds to their securities broker-dealers in excess of Section 23A limits. Thus, what you have heard as legal firewalls tend to break down the time gets tough and they are really under severe pressure because the regulators will opt for financial stability.

The Bank of England tried to say we are not going to support moral hazard by helping mortgage lenders. But when Northern Rock experienced a bank run, they decided they better step in and support it, moral hazard or not.

As to the third question, I think it is clear from the previous panel that the FDIC does not have adequate supervisory powers over commercial owners of ILCs. They clearly do not have a full power to examine the commercial parent company and they do not have the authority to impose capital requirements on either the parent company or non-bank affiliates of the parent company.

The question then would be well, should you then give the FDIC consolidated supervision over commercial parent companies? In my view, that would be an equally bad move because look at the results. First of all, the FDIC would have a tremendous increase in the supervisory burden. They would have to hire new personnel who were familiar with many different areas of our economy.

More importantly, in my opinion, the FDIC's designation as consolidated supervisor would have the undesirable effect of implying that the Federal Government is now monitoring and assuring the

overall solvency and stability of every commercial firm that owns an ILC. That would certainly lead the market to believe that the Federal Government would help commercial parents if they got in difficulty.

Moreover, it would greatly increase the intrusion of Federal regulation into our commercial sector. Certainly, I think if you begin to have the FDIC supervising people like Home Depot and Wal-Mart, one can only imagine the interference with the ordinary market dynamics of our U.S. economy. So consolidated supervision is not the answer. It is not going to solve the problems created by commercial ownership of ILCs.

I also believe that major commercial firms that acquire ILCs are likely to use political influence to obtain subsidies or forbearance from regulators. Certainly, big banks have proven to be both too big to fail and too big to discipline adequately in the past. I could give examples, if you would like to hear them.

But let me point to the FDIC's decision in 2006 to waive its ILC moratorium and to improve GM's sale of control of GMAC and its ILC subsidiary.

Senator BROWN. Please summarize, please.

Mr. WILMARTH. I am sorry, my clock was not working. May I just complete this point?

Senator BROWN. Yes.

Mr. WILMARTH. They basically granted that waiver because they felt that GM had to have that transaction. They had to be able to sell the ILC majority control in order to get funding that GM badly needed.

If they would do it for GM, they would waive their own moratorium, I think that suggests what would happen if major commercial owners get into difficulty and the Federal regulators are faced with either supporting this ability of the owner or enforcing their regulations.

In my view, Congress made exactly the right choice in 1956, 1970, 1987, and 1999 when it prohibited commercial ownership of FDIC-insured depository institutions. I think it is now time for Congress to do the same thing with regard to ILCs.

Thank you very much, and I appreciate your attention.

Senator BROWN. Thank you, Mr. Wilmarth.

Mr. Wallison, welcome.

STATEMENT OF PETER WALLISON, ARTHUR F. BURNS FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. WALLISON. Thank you. And thank you, Mr. Chairman, and the members of this Committee, for the opportunity to appear before you and discuss the issue of industrial loan companies and ILCs.

Those who want to change the current law argue that allowing non-financial companies to acquire ILCs violates the policy of separating banking and commerce. In my prepared testimony, I reviewed the underlying arguments for this policy and tried to show that the separation idea no longer has any rational basis. Instead, the policy now serves principally to protect the banking industry against competitive entry and to deprive consumers of the benefits that would flow from allowing non-financial firms to gain access to

the functions that are currently available now only to insured banks.

As I noted in my prepared testimony, by authorizing securities firms to acquire banks, and vice versa, in the Gramm-Leach-Bliley Act Congress had to conclude that no harm to an affiliated bank would result from this relationship. The essential point here is that there is no real difference between banks being owned by say securities firms, which is permissible of course under the Gramm-Leach-Bliley Act, and banks being owned by commercial firms. In both cases, all of the dangers cited by the proponents of separating banking and commerce could occur.

Securities firms, for example, which are heavy users of credit, could lend preferentially to a securities affiliate. That is, a bank that had an affiliate that was a securities firm could lend preferentially to that securities affiliate. It could refuse to lend to competitors of the affiliate. That is the conflict of interest argument that is made. And it could be overreached and forced to lend to a weak securities affiliate or other parent which could not get credit elsewhere. All those things are possible now under the Gramm-Leach-Bliley Act.

However, even those these things are possible, Congress made no special provision to prevent them when it passed the Gramm-Leach-Bliley Act. It follows that Congress must have concluded that the harms supposedly associated with banks being acquired by commercial firms are exaggerated or non-existent. This is probably because all of the acts that I have described and all of the acts that have been alleged by people on this panel and on others would be violations of banking law and regulations. And if they occurred, would subject the officials who approved these actions to criminal liability and personal penalties—personal penalties—of up to $1 million per day.

Under these circumstances, it is fanciful, I think, to believe that banks or ILCs, which are both carefully examined and supervised, would do the things that are alleged by those who claim that the policy of separating banking and commerce should continue in force and be applied to ILCs.

Not only are there no sound policy reasons for applying the separation in banking and commerce to ILCs, but doing so would cause harm to consumers and working families. Companies that sell goods and services to the public, retailers, auto companies, others, can save significant cost by gaining access to the payment system through an affiliated depository institution such as an ILC. In today's price competitive world, these savings are passed on to consumers. To the extent that commercial firms are denied this opportunity, consumers and working families are the losers.

In addition, prohibiting commercial firms from acquiring banks and ILCs deprives the banking industry of capital, innovation, and the competitive entry that will improve services and reduce costs.

So if the separation of banking and commerce has no sound policy basis and hurts consumers and working families, why is it still around? One reason is Oliver Wendell Holmes' observation that a good catchword can obscure analysis for 50 years. When it was first adopted, the policy had some justification. Banks could not compete

easily across State lines and access to bank credit was crucial to the success of a business and to personal well-being.

But 50 years later, since the liberalization of banking laws in the 1980's and 1990's, these arguments no longer have merit. Credit is now widely available from securities firms and finance companies as well a banks, and banks are competing aggressively for customers. But unfortunately, like many outmoded policies that are not reconsidered, this one protects the banking industry from competition despite statements in Congress about a desire to help consumers and working families. Indeed, it took 66 years to eliminate the Glass-Steagall Act, which protected the securities industry from bank competition and also had no sound policy justification.

For these reasons, Congress should leave the current law on ILCs unchanged. Holding open this opportunity for financial firms to combine with insured depository institutions will be an important and useful experiment. Congress can watch how this structure works, see the benefits it will provide to consumers, and determine whether any of the supposed dangers actually arise. In the end, I am confident that Congress will find that the great hue and cry stirred up about ILCs was wholly unnecessary.

Thank you, Mr. Chairman.

Senator BROWN. Thank you very much, Mr. Wallison.

Ms. Kelly.

STATEMENT OF BRIGID KELLY, DIRECTOR OF POLITICS AND COMMUNICATION, UFCW LOCAL 1099

Ms. KELLY. Thank you, Senator Brown, and thank you, Senator Bennett, for holding this hearing and for the opportunity to testify here today. I am here representing the United Food and Commercial Workers International Union, UFCW, and Local 1099, which represents the great States of Ohio, Indiana, and Kentucky. Local 1099 represents almost 20,000 members and UFCW represents more than 1.3 million. We represent workers in every State and are the largest private sector union in North America.

I am proud to represent UFCW and our members in Ohio, Indiana, and Kentucky to discuss the important issue of regulating industrial loan companies. I am especially proud to represent Ohio, home of the late U.S. Representative Paul Gillmor. Representative Gillmor was the original cosponsor of the Gillmor-Frank ILC legislation in the House, and I am pleased to be here to carry on the Ohio tradition of fighting to close the ILC loophole and keep banking and commerce separate.

UFCW recognized the problems with the ILC loophole years ago and our union was one of the founding members of a diverse group of organizations known as the Sound Banking Coalition. In addition to the UFCW, the members of the coalition include the Independent Community Bankers of America, the National Association of Convenience Stores, and the National Grocers Association.

Together with the members of the Sound Banking Coalition, UFCW has analyzed ILCs, their growth, their regulation, and their use by commercial entities. We are concerned that ILCs and their parent companies are not subjected to consolidated supervision by the Federal Reserve Board at the holding company level. This is troubling because we have seen many bank failures in the past.

And when banks fail, people get hurt, and we all end up paying in one way or another.

The savings of real people and real businesses are in these institutions and it is appropriate that we take seriously our obligation to protect people's money.

As we have learned over the course of the past century, we are far better off with prudent financial oversight of the entire bank holding company, enabling a strong regulatory agency to understand the institution and address any problems before they become too big to solve.

If I may take a few minutes to talk about our situation in Ohio, Ohio does not have an ILC charter, but we do allow banks from other States to branch into Ohio, including ILCs. Some States, including Kentucky, have passed legislation taking different approaches to stop ILCs from branching into their States, but Ohio has not. We need Congress to act so an ILC from another State with inadequate holding company regulation may not branch into Ohio.

The Sound Banking Coalition is united in support for separating banking and commerce. Separation of the financial from the commercial spheres has proven to be sound economic policy. Banks are supposed to be neutral arbiters of capital, providing financing to customers on an unbiased basis, unencumbered by commercial self-interest and competition. If those banks are owned by commercial companies, the conflicts of interest can skew loan decisions and lead to systemic problems.

Imagine, local businesses having no alternative but to go to a bank owned by a competitor for a loan. This conflict of interest could force local retailers to essentially provide their business plans to their competition.

This is a large part of the reason why Wal-Mart's attempt to buy an ILC was such a threat. We have watched Wal-Mart come into town after town and decimate Main Street business by business. Studies have documented the impact on employment, wages, benefits, and tax revenue. If Wal-Mart had secured its bank and turned its standard slash and burn tactic against local banks, its economic control in these small communities would have been almost complete.

Despite its withdrawal from the ILC market, Wal-Mart continues to loom large over the ILC debate. Although we are pleased the company withdrew its ILC application, its bid for a bank put the spotlight on ILCs in general, and on the separation of banking and commerce specifically. It is absolutely certain that if the company had secured a bank through a loophole in the law, the ILC loophole would have been larger than the law. And quite frankly, we do not believe that Wal-Mart has permanently given up going into the banking industry.

Even with Wal-Mart, there are now a record number of commercial companies applying for ILC charters: BlueCross Blueshield, Home Depot, Berkshire Hathaway, these and more have followed Wal-Mart's lead thus far. While some applications have been withdrawn, it is clear that there is unprecedented interest in this charter from commercial companies.

The FDIC has extended its moratorium, as referred today, on ILC applications submitted by commercial entities. The moratorium will not last forever, and in the meantime fundamental policy decisions must be made. These decisions are beyond the scope of the FDIC's authority and they are too important to be left to a single State.

We believe the Senate must now act for all these reasons. We believe the Senate must follow the House and pass legislation. As you know, the House passed ILC legislation with an overwhelming vote of 371 to 16.

We look forward to working with every member of this Committee and the Senate to move this legislation. I urge you to consider addressing these problems and challenges that I have outlined today.

Thank you again for your time, and I will be happy to answer any questions that you may have.

Senator BROWN. Thank you, Ms. Kelly.

Mr. Singh.

STATEMENT OF J.J. SINGH, VICE PRESIDENT, FINANCIAL AND COMMUNICATIONS SERVICES, FLYING J, INC.

Mr. SINGH. Mr. Chairman and members of the Committee, I thank you for the opportunity to appear before you to discuss Transportation Alliance Bank and the industrial banks. I am J.J. Singh and today, on behalf of the Utah Association of Financial Services, which is a trade association, I am representing industrial banks and consumers lenders in Utah and in Nevada.

I am also the President of Transportation Alliance Bank, which is located in the great State of Utah, in Ogden. We provide a full range of banking services to our clients, who I will talk about in a moment.

Frankly, sitting here for the first time, and I appreciate the opportunity, and listening to some of the things being said here, I have begun to think whether I actually have been running an industrial chartered bank in the last 5 years. I will make some observations to that effect when I get further into my testimony.

Transportation Alliance Bank is a wholly owned subsidiary of a privately held company, it is Flying J, Inc., which has travel plazas in 40 States and seven provinces in Canada. We are the 17th largest privately held company. It really, among other customers, is a home for truckers away from home. Truckers drive large rigs. They travel sometimes for a week, 2 weeks, 3 weeks before they get home. They need a place where they can launder their clothes, have a shower, eat their food, park their rig, and relax after a long day of driving.

I would like to use my limited time today to clarify some of the issues related to industrial banks and provide an accurate context to understand this market-driven, healthy, safe, and sound industry that many people think is the best model for banks in the current economy.

But to talk about Transportation Alliance Bank, I am here first to talk about the customers it serves. The customers it serves is the trucking industry, which in this country comprises about three-quarters of a million entities. Trucking serves about 80 percent of

the communities in this country. It has a revenue about $625 billion and contributes about 5 percent to the gross domestic product of this country.

If you look at this sector you will find, and this is from the U.S. Department of Transportation, 91 percent of motor carriers have 20 or fewer trucks. In essence, these are small business owners. I am not here to talk about large trucking companies. This segment, which is less than 20 trucks, is really the wellspring from which the future entrepreneurs, the larger entrepreneurs in trucking emerge from. That is the focus of Transportation Alliance Bank.

Now why do we think we are better than others in this niche market? The fact is, we understand the business. We understand the business risks inherent there. And we know how to mitigate those risks and work with those clients to provide them services in a profitable manner, in a safe and sound manner, and meeting all of the laws of the land. I will touch on those in a moment.

This is what, about 15 years ago, the CEO of Flying J recognized, that these small owner-operators actually were undercapitalized in the liquidity issues. And that was basically the rationale for us to look at getting into the banking business. The only charter that would allow us to do that was the ILC charter in the home State of Utah.

We have hundreds of customers, most of them small. And as it may seem contrived or coincidental, but the example I am going to present here is from the state of Ohio. A gentleman by the name of Gregory Arthur, 4 years ago he came to us after talking to mainstream banks, looking for a loan for a truck. Our loan officer sat down with him and actually provided him with a loan after we felt he had a sound plan. He is still a customer 4 years later. He does revenues of about $500,000 today, and frankly, is a contributing entity to business in this country.

There are hundreds of examples I can give you on that score.

Thanks to the industrial bank charter, Transportation Alliance Bank has been in business for about 9 years. It currently has assets of about $500 million and provides a host of services to the trucking industry. It makes CRA investments into local community and its efforts are rated highly by the regulators. It is a very safe and sound bank, serving primarily the needs of the segment that I was talking about.

I contend, as I talk to my peers, that this is also true for other industrial banks in Utah, which are demonstrably among the strongest and the safest banks in the Nation, and have been for some time. That has been talked by Commissioner Leary, so I will not spend much time on that. But I should mention that these banks do business not in Utah, a robust economy. But most of their business is done in the other States.

Based on my experience, there is no deficiency in the regulation of these banks or their holding companies. The regulation of industrial banks is equal to and, in some respects, stronger than the regulation of other depository institutions. There is also extensive effective regulation of the holding companies and affiliates. I have gone through about four or five safety and soundness audits. In each one of those audits, the FDIC auditors and the State auditors have asked me for information on financial companies business

about my parent corporation. As a matter of fact, in about 3 weeks the State regulators have invited FDIC to do an audit of the holding company, Flying J, Inc. We are pleased to have the regulators there to do that. As a matter of fact, we welcome them and we have no issues when the regulators contacted us to actually do an audit where the auditors have spent 2 to 3 weeks at our holding company.

So when I hear that there is no regulation of holding companies, I find it rather surprising.

Nor is it the case that traditional holding company regulation provides better protection for a bank subsidiary. As a matter of fact, my views to the contrary. Large diversified holding companies have better financial strength to support the banks that have the industrial loan charters. In my experience, I have never had the issue of not getting financing when I have needed it from my parent. And as I talk to my peers, that seems to be the case. And in some cases, there are specific commitments that the holding companies made as part of the completion of the application process to protect the bank.

Senator BROWN. Mr. Singh, please summarize, if you could. Thank you.

Mr. SINGH. There is one point I would like to make, Mr. Chairman, and this is important, mixing of commerce and banking. 23A and 23B provides us with the regulatory regime to do that, and that is pretty vigorously implemented by the regulators when they do audit us.

In conclusion, if you peel away all of the political rhetoric, the real issue regarding industrial banks is whether the large number of competent and legitimate businesses in our Nation that offer bank quality products and services will be allowed to operate in the most efficient and profitable manner, providing superior value to its customers in a safe and sound manner. That is really the whole issue.

With that, I close and will be glad to answer any questions that you may have.

Senator BROWN. Thank you, Mr. Singh.

Mr. Wallison, I ask your permission to steal your Oliver Wendell Holmes quote and request that you never use it when speaking in Ohio, if that would be OK.

[Laughter.]

Senator Bennett will begin the questions, his 5 minutes. I am going to slip out just for a moment. I have some students from Ohio here I need to see, but will return as his questioning is going on.

Thank you.

Senator BENNETT. Thank you very much, Mr. Chairman.

I used to own a business in Japan. I know a little bit about the Japanese banking system and the Japanese pattern of supporting entrepreneurial activities. I reject the idea that the Japanese model is in any way illustrative of what we are talking about here.

Mr. Wilmarth, you talk about GMAC. That is an example of the regulators giving into political pressure when GM sold that, and that that is a sample of what is going to happen.

Mr. WILMARTH. I did not say they gave in to political pressure. I think they felt that they were under considerable pressure to help a major corporation get out of a very difficult box. And they were willing to waive their rules to help them do that.

Senator BENNETT. Do you see that as a bad thing? That they were willing to allow a corporation to sell a profitable asset to take care of shortfalls in their own situation? The sale was not detrimental, in any way, to the marketplace. The sale did not put any assets at risk. The sale did not create any safety and soundness problem. All it did was say GM, you have got a problem. You have got a profitable asset that you want to sell, and we are going to let you sell it.

How does that have anything to do with what we are talking about here?

Mr. WILMARTH. My point was a broader one, which is that Federal regulators are willing to bend their rules and established policies when they are faced with significant problems that could affect financial stability. I actually gave three examples. One was——

Senator BENNETT. Wait a minute. You say they are willing to bend their rules——

Mr. WILMARTH. Yes.

Senator BENNETT [continuing]. When they are faced with a safety and soundness challenge. This was not a safety and soundness challenge in any way. This was General Motors having liquidity problems.

Mr. WILMARTH. Well, with all respect, it was a safety and soundness problem to General Motors, the parent.

Senator BENNETT. All right. Does that mean that their ownership of the ILC was a risk? Their ownership of the ILC was a benefit.

Mr. WILMARTH. Well, let me give the other two examples: the Federal Reserve waiving Section 23A to let banks help out their securities affiliates when they were under considerable stress; and the Bank of England deciding to drop its distaste for moral hazard when it had a bank run facing it.

Senator BENNETT. I do not think we need worry about the Bank of England.

Mr. WILMARTH. Well, we have done the same thing in this country, as well.

Senator BENNETT. Mr. Wallison pointed out that the kinds of things you were talking about are perfectly available now throughout the entire financial securities industry. So why do we say it is terrible that a major national commercial firm, with tremendous financial resources, will be treated differently than a financial services firm whose resources may not be as great? Why is that a greater—I cannot fathom why that is a greater risk systemically to the American economy than what we are talking about here.

Mr. WILMARTH. My concern is how far do we spread the Federal safety net? I think everyone now is seeming to say, which I regret I felt at the time of Gramm-Leach-Bliley, we now seem to have spread the Federal safety net to embrace entire financial conglomerates, not just banks.

Senator BENNETT. Are you suggesting that by owning that ILC, General Motors had access to FDIC deposits?

Mr. WILMARTH. They certainly had access to FDIC deposits. Look at——

Senator BENNETT. For General Motors' purposes?

Mr. WILMARTH. Merrill Lynch, for example, has gained $70 billion of deposits and they have said publicly that this is the best funding source they have ever found. It is a much cheaper funding source than when they used to have to go to the financial markets and sell commercial paper.

The question is how large do these ILCs become? If every commercial organization held an ILC the size of Merrill Lynch, yes, I think you would see quite a bit of subsidization, in my opinion.

Senator BENNETT. And yet, even the legislation passed by the House would allow Merrill Lynch to continue to own that ILC. So the example you have given us as typical of the kind of threat we are facing, is an example that the proposed legislation continues.

Mr. WILMARTH. Again, the question is do you want to extend the Federal safety net beyond the financial sector into the entire commercial sector. That is, I believe, what is now at stake.

Senator BENNETT. Well, I obviously have problems with your testimony and I am glad Mr. Wallison followed you immediately, because we have a pretty clear clash here between the two.

I probably ought to calm down, Mr. Chairman, so I will quit there.

Senator BROWN. Darn, I wish I had watched that, Senator Bennett.

[Laughter.]

Thank you.

Mr. Yingling, Mr. Wallison's comments about competition were interesting, I thought. And while you may not have as good a quote as he did on Oliver Wendell Holmes, tell me why he is wrong about the banking? I have been here now, I have been on this Committee for I guess 9 months. I have been perhaps not amazed, but certainly intrigued by the number of actors in the financial services business, from non-bank lenders to the Farm Credit System, credit unions, traditional banks, payday lenders, the Government itself, in all kinds of competition.

Tell me why he is—expand on that, why he is wrong about the whole point of this is anticompetitive.

Mr. YINGLING. Well, I think it is quite clear that we have a very, very competitive financial system with lots and lots of players, as you are pointing out. I think theory would tell you that more players means more competition. So the question has to be what are the other public policy issues that are inherent in adding maybe more marginal competition. I do not think it is an area that lacks plenty of competition right now.

And I think the basic public policy issue is that if the Congress does not act fairly soon, the ILC provision could become a vehicle that results in a major change in the structure of our financial system. So that, at the risk of Senator Bennett calling me Chicken Little, I will say that you could see a situation 10 or 20 years from now where we have a very different financial system in which you have industrial companies, commercial companies with banks embedded in them that dominate the financial system. And I think

that raises some very serious questions about how lending might take place, about the ability to have a very flexible system.

I do think that, with respect to some countries, we have seen that a financial system dominated by big conglomerates lacks flexibility. That may affect the ability to lend to smaller companies. And it also may mean when you have a problem, it is more difficult to get out of it.

One of the great things we see in our financial system, because of its flexibility, is we are able to get out of problems more quickly than some countries. I think hopefully, in the problem that we have right now that this Committee is so concerned about with subprime lending, we find that the commercial banking system and the savings institutions in this country are in a position now to step back in and help lend to people that need the housing loans.

Senator BROWN. Thank you.

Ms. Kelly, some have argued that this whole issue is about Wal-Mart. Since they have withdrawn their application, is there a reason to move forward? If you substitute some other big retailer's name, is that then a problem?

Ms. KELLY. I would say that regardless of whose name is on the outside of the building, if you have a large retailer who is coming in to try and, you know, just add banking sort of as another product line, that it is a problem.

Working people are concerned about their money. I mean, even though some of our members make minimum wage, they are concerned about where their money goes. But if you have a company that comes into a town, specifically a small town, and takes over the hardware store and the florist and the bakery and the grocery store, and then they have to be your bank, too, that is a problem for us, whether it is Wal-Mart or another large retailer.

I think that the primary problem is a separation of banking and commerce. I mean, that is a fundamental problem, regardless of whose name is on the outside of the big box.

Senator BROWN. Thank you.

Mr. Lackritz, I do not think anybody is arguing for duplicative regulation, just one regulator. Since that is absent in the case of commercial parents of ILCs, shouldn't we close that loophole?

Mr. LACKRITZ. Well, I think, from the standpoint of addressing that, we would not—we do not need to reach that question because in the situation that we are talking about, we are talking about broker-dealers, who are basically financial in nature to begin with.

And the question there is making sure that we do not have overlapping, duplicative, or redundant regulation along the way. So that the consolidated supervised entity regime that the SEC has put in place, for those five large global institutions, really serves as a very good oversight from the standpoint of the same kinds of concerns that have been raised with respect to oversight of financial services holding companies and bank holding companies, as well.

So with respect to the commercially owned situation, we do not need to get that far because we have really got a regime now that actually works extremely well and has been very innovative from the standpoint of the SEC and sort of our global competitors.

Senator BROWN. Thank you.

Thank you all, both the first panel and the second panel. And thank you, the two of you, for coming a little further, from Cincinnati and from Utah, to join us.

Senator Bennett, thank you for your passion and your comments.

The Committee is adjourned.

[Whereupon, at 12:27 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

I want to thank Senator Brown for chairing today's hearing and thank Ranking Member Shelby for his cooperation in putting this hearing together, as well.

Industrial loan companies, or ILCs, are state-chartered and state-regulated depository institutions regulated primarily by the Federal Deposit Insurance Corporation (FDIC). They enjoy a unique status within America's financial services landscape, the result of the Competitive Equality Banking Act (CEBA) of 1987. ILCs can engage in most banking activities under specific state laws and are eligible for FDIC insurance, but are designated "non-banks" exempt from the statutory, and supervisory, framework of the Bank Holding Company Act, which restricts the mixing of banking and commercial activities for bank holding companies and their affiliates.

In recent years, we have witnessed a significant increase in the size and number of ILCs, and applications to acquire ILCs being filed with the FDIC, leading to increased focus on the ILC charter and regulatory structure. Most recently, Wal-Mart, Home Depot, and several other large commercial firms applied to the FDIC for the right to acquire ILCs. The Wal-Mart application, in particular, triggered fierce opposition on various grounds from an array of interest groups, resulting in thousands of comment letters being filed with the FDIC.

The public and congressional opposition to the Wal-Mart application led the FDIC to impose a six-month moratorium on ILC applications. The agency decided to extend that moratorium an additional year, through January 31, 2008, though applied solely to application for ILCs to be owned or controlled by commercial firms. In extending the moratorium the FDIC sought to allow Congress to consider, and ultimately decide upon, the public policy question brought about by the Wal-Mart application, including the public policy implications of the mixing of banking and commerce as it relates to ILC ownership by commercial firms.

Today's hearing provides the Committee with an important opportunity to hear from a broad spectrum of stakeholders on all sides of the ILC debate—regulators, industry representatives, academics and concerned citizens. It is my hope that Committee members will come away from this hearing with a better understanding of the regulation and supervision of ILCs; a historical perspective on the evolution of the ILC structure; an understanding of the public policy concerns related to the mixing of banking and commerce and commercial ILC ownership; and an awareness of the arguments in favor of and in opposition to such combining. Most importantly, Committee members will hear a wide array of views from our witnesses on ways to enhance, strengthen or reform the ILC charter.

I want to again thank Senator Brown for chairing today's hearing. And I extend my thanks to all of the witnesses for taking the time to come before the Committee today on this timely issue. I look forward to reviewing the witness testimony, and the hearing transcript, and working with my Committee colleagues moving forward towards a process that I hope will result in bipartisan ILC legislation moving out of this Committee in the coming weeks.

PREPARED STATEMENT OF SENATOR SHERROD BROWN

Good morning, and thanks to everyone for joining us here today as the committee examines the role that industrial loan companies, or ILCs, play in our banking system.

That system is a continually changing one, as lenders innovate and Congress from time to time responds to the changes in the landscape.

Amidst this change, some principles remain constant. Four times in my lifetime, Congress has acted to separate commercial firms from banks and vice versa.

Time and again, we have seen the real costs when Congress has failed to act, from the Depression to the Savings & Loan crisis. Frankly, we are seeing variations of the problem today. In Japan, the intermingling of commerce and banking has led to disastrous results. And here at home where the sub-prime mortgage meltdown has operated largely outside of federal supervision.

I have been pretty candid all year about what I think has been the failure of the Federal Reserve to act more aggressively to police the sub-prime non-bank lenders. It wouldn't be inaccurate if our witness from the Federal Reserve made the same observation about Congress and ILCs.

We need to act this fall to address this problem, just as we have repeatedly in the past. When commercial firms set up single bank holding companies, Congress amended the law in 1970 to reach them. When commercial firms started buying non-bank banks, Congress in 1987 stepped in again. When commercial firms started to acquire thrifts, Congress responded with Gramm-Leach-Bliley in 1999.

And this spring, in the wake of the tremendous growth in industrial loan company assets since Gramm-Leach-Bliley, almost eightfold, the House adopted Representative Paul Gilmor's bill to prevent further commercial acquisitions of ILCs by a vote of 371 to 16.

The strength of that vote is a small testament to the respect in which Paul was held, and the skill with which he did his job as a legislator.

Congress lost a real expert in these issues with his passing, and Karen and the rest of his family and friends lost a good man. I hope we can pick up where he left off.

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Before I make a few comments regarding the regulation and supervision of ILCs, I would like to thank Chairman Dodd for placing the ILC issue on the top of his agenda for this fall. I would also like to thank Senator Brown for chairing this hearing, as well as for his interest and commitment to this very important issue.

The ILC issue raises questions that I believe the Senate must consider: whether the scope and purpose of industrial loan companies have expanded beyond their original purpose to serve the needs of industrial workers; whether FDIC supervision and regulation of ILCs needs to be strengthened; whether ILCs should be subject to the consolidated supervision framework established in Gramm-Leach-Bliley; and whether the ILC loophole should be closed. The House of Representatives has already addressed these issues with their bipartisan bill, H.R. 698.

To give some historical perspective, the current debate surrounding the commercial ownership of ILCs is not unlike the debate surrounding the Gramm-Leach-Bliley Financial Services Modernization Act of 1999, and efforts to close the loophole that allowed any commercial firm to buy a unitary thrift holding company. Congressman Jim Leach, Congressman Steve Largent and I introduced an amendment to close the unitary thrift loophole. Despite significant opposition, the loophole was closed, thus eliminating a dangerous threat to the erosion of the division between banking and commerce.

It appears that the ILC loophole, like the unitary thrift loophole, is expressing itself as another avenue toward the mixing of banking and commerce. This is evidenced by the increasing number of commercial companies that have taken advantage of the exemption that allows ILCs to own and operate banks outside of the supervisory and regulatory framework established by Congress many years ago.

Fifty nine ILC charters have been granted since 1984 with Federal Deposit I insurance, with one half of these after 1999. Additionally, assets of ILCs grew from $3.8 billion in 1987 to over $155 billion in 2006. I think these numbers are telling of the potential danger this loophole poses.

Today, ILCs are able to engage in many of the same types of activities as other FDIC insured depository institutions. And since Gramm-Leach-Bliley, this charter is the only vehicle through which commercial companies and non-bank entities can control an insured depository institution and engage in banking activities.

I don't think that Congress could have predicted the level of growth that ILCs have experienced, and even though we specifically created exceptions for ILCs in 1987, that does not absolve us of our responsibility to carefully review the changes in the current landscape and respond thoughtfully and carefully.

Today, though, we are under a time constraint. In July of 2006, the FDIC placed a six month moratorium on any applications for deposit insurance by an ILC. In January of 2007, that moratorium was extended for an additional year on applications for deposit insurance and change in control notices ILCs owned by commercial companies. This moratorium was extended to provide Congress with the opportunity to address the safety and soundness issues surrounding commercial ownership of ILCs under existing law. The FDIC awaits action and guidance from the Congress before the moratorium expires on January 31, 2008. That said, Congress has established a framework for maintaining the separation of banking and commerce time and time again.

Senators Brown and Allard, and I introduced S. 1356 in May. I believe this legislation addresses the regulatory and supervisory concerns of the ILC loophole, but I also recognize that this is not the only way to approach this issue. I look forward to working with my colleagues on the Banking Committee to find a workable solution to the regulatory and supervisory concerns and the potential risks posed by commercial ownership of ILCs.

In addition, to my statement for the record, I would also ask that I am able to submit two letters from the South Dakota Bankers Association and the Independent Community Bankers of South Dakota highlighting the importance of this issue to

my state's communities, the written testimony I provided the FDIC on April 10, 2006 for their hearing on the Proposed Wal-Mart Bank's Application for Federal Deposit Insurance, and the GAO's September 2005 study titled "Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority" for the record.

PREPARED STATEMENT OF SENATOR JACK REED

Thank you Chairman Brown and Senator Shelby for holding this hearing on industrial loan companies.

Industrial loan companies, started in the early 1900's, were chartered to make uncollateralized loans to industrial workers. More recently, the ILC industry has experienced tremendous growth, while growing more complex. During a 20 year period ending in 2006, ILC assets grew more than 3,900 percent from $3.8 billion to over $155 billion. While the early ILCs were small and helped to fill underserved areas of our economy, today's ILCs closely resemble commercial banks in the products and services offered and are owned by some of the largest U.S. financial companies. They therefore require the same level of oversight as traditional depository institutions.

A July 12, 2006 GAO report on ILCs outlines a critical area of ILC regulatory oversight in need of strengthening. According to this GAO report, "Although FDIC has supervisory authority over an insured ILC, this authority does not explicitly extend to ILC holding companies, and therefore, is less extensive than the authority consolidated supervisors have over bank and thrift holding companies." The report concludes that ". . . from a regulatory standpoint, these ILCs may pose more risk of loss to the bank insurance fund than other insured depository institutions operating in a holding company." While a history of a healthy and successful ILC industry would indicate that the bank-centric model has worked in the past, the growth in size and complexity of these institutions is reason enough to address this supervisory blind spot. Furthermore, the FDIC's authority has yet to be tested by the parent company of a large, troubled ILC during stressed times.

The mixing of banking and commerce in the United States is a long-standing issue and, while there have been exceptions, there has been an effort to keep the two separate. Critics of the idea of mixing banking with nonfinancial entities express a concern that the risks will far outweigh the benefits. These risks include conflicts of interest; the creation of economic power in banking, which could impair competition; and an expansion of the federal safety net. Given recent changes in the ILC industry, we should assess our position on separating banking from commerce and determine an appropriate tolerance for mixing the two, while not punishing those that have followed the law to date.

From their early history, ILCs have filled a niche, and the industry has operated in a safe and sound manner. I look forward to discussing the issues and coming up with solutions that allow for the ILC industry to continue thriving, while addressing regulatory gaps. I want to thank the regulators for working together on this issue and I look forward to your testimony.

United States Government Accountability Office

GAO

Report to the Honorable James A. Leach, House of Representatives

September 2005

INDUSTRIAL LOAN CORPORATIONS

Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority

GAO-05-621

Highlights

Highlights of GAO-05-621, a report to the Honorable James A. Leach, House of Representatives

Why GAO Did This Study

Industrial loan corporations (ILC) emerged in the early 1900s as small niche lenders that provided consumer credit to low and moderate income workers who were generally unable to obtain consumer loans from commercial banks. Since then, some ILCs have grown significantly in size, and some have expressed concern that ILCs may have expanded beyond the original scope and purpose intended by Congress. Others have questioned whether the current regulatory structure for overseeing ILCs is adequate.

This report (1) discusses the growth and permissible activities of ILCs and other insured depository institutions, (2) compares the supervisory authority of the FDIC with consolidated supervisors, and (3) describes ILC parents' ability to mix banking and commerce.

What GAO Recommends

GAO is not recommending executive action but believes Congress should consider strengthening the regulatory oversight of ILCs and more broadly consider the advantages and disadvantages of a greater mixing of banking and commerce by ILCs or other financial institutions. In commenting on a draft of this report, the Board agreed with both the findings and matters for congressional consideration. FDIC agreed with one of the findings but generally believed that no changes were needed in its supervisory approach.

www.gao.gov/cgi-bin/getrpt?GAO-05-621.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov.

September 2005

INDUSTRIAL LOAN CORPORATIONS

Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority

What GAO Found

The ILC industry has experienced significant asset growth and has evolved from one-time, small, limited purpose institutions to a diverse industry that includes some of the nation's largest and more complex financial institutions. Between 1987 and 2004, ILC assets grew over 3,500 percent from $3.8 billion to over $140 billion. In most respects, ILCs may engage in the same activities as other depository institutions insured by the FDIC and thus may offer a full range of loans, including consumer, commercial and residential real estate, small business, and subprime. ILCs are also subject to the same federal safety and soundness safeguards and consumer protection laws that apply to other FDIC-insured institutions. Therefore, from an operations standpoint, ILCs pose similar risks to the bank insurance fund as other types of insured depository institutions.

Parents of insured depository institutions that provide similar risks to the bank insurance fund are not, however, being overseen by bank supervisors that possess similar powers. ILCs typically are owned or controlled by a holding company that may also own other entities. Although FDIC has supervisory authority over an insured ILC, it has less extensive authority to supervise ILC holding companies than the consolidated supervisors of bank and thrift holding companies. Therefore, from a regulatory standpoint, these ILCs may pose more risk of loss to the bank insurance fund than other insured depository institutions operating in a holding company. For example, FDIC's authority to examine ILC affiliates and take certain enforcement actions against them is more limited than a consolidated supervisor. While FDIC asserted that its authority may achieve many of the same results as consolidated supervision, and that its supervisory model has mitigated losses to the bank insurance fund in some instances, FDIC's authority is limited to a particular set of circumstances and may not be used at all times. Further, FDIC's authority has not been tested by a large ILC parent during times of economic stress.

An exemption in federal banking law currently allows ILC parents to mix banking and commerce more than the parents of other depository institutions. Three of the six new ILC charters approved during 2004 were for commercial firms, and one of the largest retail firms recently applied for an ILC charter. While some industry participants assert that mixing banking and commerce may offer benefits from operational efficiencies, empirical evidence documenting these benefits is mixed. Federal policy separating banking and commerce focuses on the potential risks from integrating these functions, such as the potential expansion of the federal safety net provided for banks to their commercial entities. GAO finds it unusual that a limited ILC exemption would be the primary means for mixing banking and commerce on a broader scale and sees merit in Congress more broadly considering the advantages and disadvantages of a greater mixing of banking and commerce.

Contents

Letter

Letter		1
	Results in Brief	5
	Background	10
	ILCs Have Grown Significantly and Are No Longer Small, Limited Purpose Institutions	16
	ILC Business Lines and Regulatory Safeguards Are Similar to Other Insured Financial Institutions	21
	FDIC's Supervisory Authority Over ILC Holding Companies and Affiliates Is Not Equivalent to Consolidated Supervisors' Authority	27
	FDIC Actions May Help Mitigate Potential Risks, but Supervision of ILC Holding Companies and Affiliates Has Only Been Tested on a Limited Basis in Relatively Good Economic Times	48
	ILCs May Offer Commercial Holding Companies a Greater Ability to Mix Banking and Commerce Than Other Insured Depository Institution, but Views on Competitive Implications Are Mixed	65
	Recent Legislative Proposals May Increase the Attractiveness of Operating an ILC	76
	Conclusions	79
	Matters for Congressional Consideration	81
	Agency Comments and Our Evaluation	82

Appendixes

Appendix I:	**Objectives, Scope, and Methodology**	87
Appendix II:	**Comments from the Board of Governors of the Federal Reserve System**	90
Appendix III:	**Comments from the Federal Deposit Insurance Corporation**	92
Appendix IV:	**GAO Contact and Staff Acknowledgments**	98

Tables

Table 1:	Comparison of Permissible Activities Between State Nonmember Commercial Banks and ILCs in a Holding Company Structure	23
Table 2:	The Extent of Selected FDIC Authorities	38
Table 3:	Affiliate Related Examination Procedures	50
Table 4:	Comparison of Examination Resources and Organizational Structure of State Banking Supervisory Office	56

Table 5: Causes of Material ILC Failures and FDIC's Response to Failures and Other Industry Conditions 60

Figures

Figure 1: Number and Total Assets of ILCs 19
Figure 2: Percentage of ILC Assets Held by Individual States 20
Figure 3: Percentage of Estimated FDIC Insured Deposits Held by ILCs 21
Figure 4: Comparison of Explicit Supervisory Authorities of the FDIC, Board, and OTS 35

Abbreviations

BHC Act	Bank Holding Company Act
Board	Board of Governors of the Federal Reserve System
CEBA	Competitive Equality Banking Act
CIBA	Change in Bank Control Act
CSBS	Conference of State Banking Supervisors
FDI Act	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FDIC-IG	Federal Deposit Insurance Corporation Office of Inspector General
FFIEC	Federal Financial Institutions Examination Council
Fund	Bank Insurance Fund
GLBA	Gramm Leach Bliley Act
HOLA	Home Owners Loan Act
IAP	Institution-Affiliated Party
ILC	Industrial Loan Corporation
IT	information technology
NCUA	National Credit Union Association
Nevada DFI	Nevada Division of Financial Institutions
NOW	Negotiable Order of Withdrawal
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
QTL	Quality Thrift Lender
SEC	Securities and Exchange Commission
Treasury	Department of the Treasury
Utah DFI	Utah Department of Financial Institutions

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United States Government Accountability Office
Washington, D.C. 20548

September 15, 2005

The Honorable James A. Leach
House of Representatives

Dear Mr. Leach:

Industrial loan corporations (ILC), also known as industrial banks, are state-chartered financial institutions that emerged in the twentieth century to provide consumer credit to low and moderate income workers who were generally unable to obtain consumer loans from commercial banks. Over the past 10 years, ILCs have experienced significant asset growth, and these one-time, small niche lenders have evolved into a diverse industry that includes some large, complex financial institutions. In addition, some commercial entities are increasingly interested in owning ILCs. For example, three large commercial entities were granted approval to open ILCs in 2004, and one of the largest retail enterprises recently applied for an ILC charter. As a result, some have expressed concerns that ILCs may be expanding beyond the original scope and purpose intended by Congress.

ILCs are typically owned or controlled by a holding company that may also own other entities, and concerns have also been expressed that the current regulatory structure for overseeing ILCs in holding companies may not provide adequate protection against the potential risks that holding companies and nonbank affiliates may pose to an ILC. The regulation of the safety and soundness of ILCs rests with the Federal Deposit Insurance Corporation (FDIC) and the ILC's respective state regulator. Under the Bank Holding Company Act (BHC Act), the Board of Governors of the Federal Reserve System (Board) generally supervises bank holding companies and has established a consolidated supervisory framework for assessing the risks to a depository institution that could arise because of their affiliation with other entities in a holding company structure. For example, the Board may generally examine holding companies and their nonbank subsidiaries, subject to some limitations, to assess, among other things, the nature of the operations and financial condition of the holding company and its subsidiaries; the financial and operations risks within the holding company system that may pose a threat to the safety and soundness of any depository institution subsidiary of such holding company; and the systems for monitoring and controlling such risks. Thus, consolidated supervisors take a systemic approach to supervising holding companies and nonbank subsidiaries of depository institutions. However, holding companies of ILCs operate under an exception to the BHC Act, and

most are not subject to Board oversight. Moreover, FDIC has not been given consolidated supervisory authority over ILC holding companies. FDIC has, however, employed what some term as a "bank-centric" supervisory approach that primarily focuses on isolating the insured institution from potential risks posed by holding companies and affiliates, rather than assessing these potential risks systemically across the consolidated holding company structure.

Another area of concern about ILCs is the extent to which they can mix banking and commerce through the holding company structure. The policy separating banking and commercial activity was largely a reaction to the perception that banks, especially those in a larger conglomerate organization, had a disproportionate amount of economic power in the period leading up to the stock market crash of 1929. The BHC Act maintains the historical separation of banking from commerce by generally restricting bank holding companies to banking-related or financial activities.[1] The BHC Act also allows ILC holding companies, including nonfinancial institutions such as retailers and manufacturers, and other institutions to avoid consolidated supervision and activities restrictions. While some industry participants have stated that mixing banking and commerce may offer benefits from operational efficiencies, the policy of separating banking and commerce was based primarily on the potential risks that combining these activities may pose to the federal safety net for insured depository institutions, as well as the potential for more conflicts of interest and the potential increase in economic power exercised by large conglomerate enterprises. Currently ILC holding companies and companies that own or control other types of insured depository institutions and other nondepository institutions, such as unitary thrifts, are permitted to mix banking and commerce to varying degrees. However, some believe that ILCs may be the entities that offer the greatest ability to mix these activities.

Currently, FDIC-insured banks, including ILCs, are not permitted to offer interest-bearing business checking accounts. Over the past several years,

[1]As amended by the Gramm-Leach-Bliley Act (GLBA), the BHC Act restricts the activities of bank holding companies to activities "closely related to banking" that were permitted by the Federal Reserve Board as of November 11, 1999. However, bank holding companies that qualify as financial holding companies can engage in additional activities defined in GLBA as activities that are "financial in nature," as well as activities that are incidental to or complementary to financial activity. Pub. L. No. 106-102 §§ 102, 103, *codified* at 12 U.S.C. § 1843(c)(8), (k) (2000 & Supp. 2004).

there have been repeated legislative proposals to repeal this prohibition and some have stated that this prohibition is unnecessary and outdated. Recent legislative proposals would grant insured depository institutions, including many ILCs, the ability to pay interest on business checking accounts and branch into other states through establishing new branches—known as de novo branching. Some have questioned whether these proposals would give ILCs a competitive advantage in the marketplace or essentially place ILCs on par with commercial banks.

This report responds to your March 4, 2004, request for a review of several issues related to ILCs. Specifically you asked us to (1) describe the history and growth of the ILC industry; (2) describe the permissible activities and regulatory safeguards for ILCs as compared with other insured financial institutions; (3) compare FDIC's supervisory authority over ILC holding companies and affiliates with the consolidated supervisors' authority over holding companies and affiliates; (4) describe recent changes FDIC made to its supervisory approach of the risks that holding companies and affiliates could pose to ILCs and determine whether FDIC's bank-centric supervisory approach protects the ILC from all the risks that holding companies and nonbank affiliates may pose to the ILC; (5) determine whether the ILC charter allows for a greater mixing of banking and commerce than other types of insured depository institutions, and whether this possibility has any competitive implications for the banking industry; and (6) determine the potential implications of granting ILCs the ability to pay interest on business checking accounts and operate de novo branches nationwide.

To describe the history and growth of the ILC industry, we analyzed data, including information on ILC assets and estimated insured deposits for the time period 1987–2004. To describe the permissible activities of and regulatory safeguards for ILCs, we reviewed federal and state legislation, regulations, and guidance regarding ILCs and banks. We also interviewed management from various ILCs and spoke with officials from FDIC; the Board; and state supervisory officials from California, Nevada, and Utah that are responsible for the safety and soundness of insured institutions. We focused on ILCs and bank supervisors in these three states because they comprise over 99 percent of the ILC industry assets. We also analyzed FDIC data on ILCs from 1987–2004. To compare FDIC's supervisory authority over ILC holding companies and affiliates with the consolidated supervisors' authority over holding companies and affiliates, we reviewed and analyzed legislation and regulations that govern the supervision of insured depository institutions, including ILCs and their holding

companies, banks and their holding companies, and thrifts and their holding companies. We also compared agency examination manuals and guidance, interviewed officials regarding the FDIC's, the Board's, and the Office of Thrift Supervision's (OTS) supervisory approaches and supervisory authorities, and spoke with state and FDIC regional staff responsible for conducting examinations. We focused our comparison primarily on the Board's authorities relating to the consolidated supervision of bank holding companies and the FDIC's supervision of ILCs, their holding companies, and affiliates from a safety and soundness perspective. However, because OTS also supervises similar institutions with similar risks, we also reviewed OTS' supervisory authority with respect to thrifts and savings and loan holding companies. To describe what recent changes FDIC has made to its supervisory approach of the risks that holding companies and their nonbank subsidiaries could pose to ILCs and determine whether FDIC's bank-centric supervisory approach protects the ILC from all the risks that holding companies and those subsidiaries may pose to the ILC, we reviewed and synthesized relevant supporting documents and the information from the two FDIC-Inspector General (FDIC-IG) material loss reviews related to ILCs. Where appropriate, after conducting our own due diligence review, we also relied upon the work of the FDIC-IG's September 30, 2004, report on limited charter depository institutions, including ILCs, that provided information on FDIC's guidance and procedures for supervising limited-charter depository institutions, including ILCs, and summarized recent actions regarding these institutions.[2] To determine whether the ILC charter allows for a greater mixing of banking and commerce than other types of insured depository institutions, and whether this possibility has any competitive implications for the banking industry and to determine the potential implications of granting ILCs the ability to pay interest on business checking accounts and operate de novo branches nationwide, we reviewed academic and other studies, relevant laws, and other documents, interviewed management from several ILCs, and hosted a panel of experts made up of academics, economists, industry practitioners, and independent consultants. See appendix I for additional details on our objectives, scope, and methodology.

[2]*The Division of Supervision and Consumer Protection's Approach for Supervising Limited-Charter Depository Institutions* (FDIC Office of Inspector General Report No. 2004-048, Sept. 30, 2004).

During this review, we did not assess the extent to which regulators effectively implemented consolidated supervision or any other type of supervision. Rather, we focused on the respective federal regulators' authorities to determine whether there were any inherent limitations in these authorities. We conducted our work in Washington, D.C.; Los Angeles, California; San Francisco, California; Las Vegas, Nevada; and Salt Lake City, Utah; between May 2004 and August 2005 in accordance with generally accepted government auditing standards.

Results in Brief

ILCs began in the early 1900s as small, state-chartered, loan companies that primarily served the borrowing needs of industrial workers unable to obtain noncollateralized loans from banks. Since then, the ILC industry has experienced significant asset growth and has evolved from small, limited purpose institutions to a diverse industry that includes some of the nation's largest and more complex financial institutions with extensive access to the capital markets. Most notably, between 1987 and 2004, ILC assets grew over 3,500 percent from $3.8 billion to over $140 billion, while the number of ILCs declined about 46 percent from 106 to 57. The amount of estimated insured deposits in the ILC industry has also grown significantly; however, these deposits represent less than 3 percent of the total estimated insured deposits in the Fund for all banks. This growth in the ILC industry has been concentrated in three states—California, Nevada, and Utah. In 2004, 6 ILCs were among the 180 largest financial institutions in the nation with $3 billion or more in total assets, and one institution had over $66 billion in total assets.

With one exception contained in federal and one state's banking laws, ILCs in a holding company structure may generally engage in the same activities as FDIC-insured depository institutions. Also, FDIC-insured ILCs must comply with the same federal requirements as other FDIC-insured depository institutions. For these two reasons, ILCs pose risks to the Fund similar to those posed by other FDIC-insured institutions from an operations standpoint.[3] Like other FDIC-insured depository institutions, ILCs may offer a full range of loans such as consumer, commercial and residential real estate, and small business loans. Further, like a bank, an

[3]Under 12 U.S.C 1831a(a), FDIC-insured state banks, a group that includes ILCs, may not engage as principal in any activity that is not permissible for a national bank unless the FDIC has determined that any additional activity would pose no significant risk to the deposit insurance fund and the bank is in compliance with applicable federal capital standards.

ILC may also "export" its home-state's interest rates to customers residing elsewhere. However, because of restrictions in federal and California state banking law, most ILCs do not accept demand deposits.[4] As a result, many ILCs offer Negotiable Order of Withdrawal (NOW) accounts—similar in some respects to demand deposits and are, therefore, able to offer a service similar to demand deposits without their holding companies being subject to supervision under the BHC Act.[5] While most ILC holding companies are not subject to supervision under the BHC Act, ILCs generally are subject to the same federal regulatory safeguards that apply to commercial banks and thrifts, such as federal restrictions governing transactions with affiliates and laws addressing terrorism financing, money laundering, and other criminal activities by bank customers.

FDIC's supervisory authority over the holding companies and affiliates of ILCs is more limited than the authority that consolidated supervisors have over the holding companies and affiliates of banks and thrifts. For example, FDIC's authority to examine an affiliate of an insured depository institution is limited to examinations necessary to disclose fully the relationship between the institution and any affiliate and the effect of the relationship on the institution. Relationships generally include arrangements involving some level of interaction, interdependence, or mutual reliance between the ILC and the affiliate, such as a contract, transaction, or the sharing of operations. When a relationship does not exist, any reputation or other risk presented by an affiliate that could impact the institution may not be detected. In contrast, consolidated supervisors, subject to functional regulation restrictions, generally are able to examine the holding company

[4]California law prohibits industrial banks from accepting demand deposits. Cal. Financial Code § 105.7 (Deering 2002). Section 2c(2)(H) of the BHC Act exempts ILCs that satisfy certain criteria from the act. The exemption applies to ILCs organized under the laws of states which, on March 5, 1987, had or were considering laws to require FDIC insurance for ILCs and includes ILCs with assets of $100 million or more that do not accept demand deposits that may be withdrawn by check or similar means for payment to third parties. 12 U.S.C. § 1841(c)(2)(H). The vast majority of ILCs exist in a holding company structure, and these ILCs' assets account for 99 percent of total ILC industry assets.

[5]NOW accounts are deposit accounts that give the depository institution the right to require at least 7 days written notice prior to withdrawal and have other characteristics set forth in Federal Reserve Regulation D. 12 C.F.R. § 204.2(b)(3) (2004). Under the Federal Deposit Insurance Act, NOW accounts may be offered to individuals and nonprofit organizations and for the deposit of public funds. 12 U.S.C. § 1832 (2000).

and any nonbank subsidiary regardless of whether the subsidiary has a relationship with the affiliated insured bank.[6] FDIC officials told us that with its examination authority, as well as its abilities to impose conditions on or enter into agreements with an ILC holding company in connection with an application for federal deposit insurance, terminate an ILC's deposit insurance, enter into agreements during the acquisition of an insured entity, and take enforcement measures, FDIC can protect an ILC from the risks arising from being in a holding company as effectively as the consolidated supervision approach. However, with respect to the holding company, these authorities are limited to particular sets of circumstances and are less extensive than those possessed by consolidated supervisors of bank and thrift holding companies.

While FDIC's bank-centric supervisory approach has undergone various enhancements designed to help mitigate the potential risks that FDIC-examined institutions, including ILCs in a holding company structure, can be exposed to by their holding companies and affiliates, questions remain about whether FDIC's supervisory approach and authority over BHC Act-exempt holding companies and their nonbank subsidiaries address all risks to the ILC from these entities. FDIC revised the guidance for its risk-focused examinations to, among other things, provide additional factors that might be considered in assessing a parent company's potential impact on an insured depository institution affiliate. In addition, FDIC's monitoring and application processes may also help to mitigate risks to ILCs with foreign holding companies and affiliates. FDIC has provided some examples where its supervisory approach effectively protected the insured institution and mitigated losses to the Fund. However, FDIC's supervision of large rapidly growing ILCs and FDIC's authority over ILC holding companies and nonbank subsidiaries, including the risks that these entities could pose to the ILC, has been refined during a period of time described as the "golden age of banking" and has not been tested during a time of significant economic stress or by a large, troubled ILC.

Because most ILC holding companies and their subsidiaries are exempt from business activity limitations that generally apply to the holding companies and affiliates of other types of insured depository institutions, ILCs may provide a means for mixing banking and commerce more than

[6]For purposes of this report, the term "bank" refers to insured depository institutions, including ILCs and thrifts. The Federal Deposit Insurance Act defines the term "bank" to include ILCs. 12 U.S.C. § 1813(a).

ownership or affiliation with other insured depository institutions. During our review, we identified other instances where the mixing of banking and commerce previously existed, or currently exists on a limited basis, such as unitary thrift holding companies, certain "nonbank banks" in a holding company, and activities permitted under GLBA, such as merchant banking and grandfathered, limited nonfinancial activities by securities and insurance affiliates of financial holding companies.[7] However, federal law significantly limits the operations and product mixes of these entities and activities as compared with ILC holding companies. Additionally, with the exception of a limited, credit-card-only bank charter, ownership or affiliation with an ILC is today the only option available to nonfinancial, commercial firms wanting to enter the insured banking business. Three of the six new ILC charters approved by FDIC during 2004 are owned by nonfinancial, commercial firms, and one of the nation's largest retailers recently filed an application to own an ILC. The policy generally separating banking and commerce is based primarily on potential risks that integrating these functions may pose such as the potential expansion of the federal safety net provided for banks to their commercial holding companies or affiliates, potential increase in conflicts of interest, and the potential increase in economic power exercised by large conglomerate enterprises. While some industry participants state that mixing banking and commerce may offer benefits from operational efficiencies, empirical evidence documenting these benefits is mixed.

Recent legislative proposals to allow insured depository institutions, including certain ILCs, to offer NOW accounts to business customers and the ability to de novo branch will expand the availability of products and services that insured depository institutions, including ILCs, could offer and may make the ownership of ILCs increasingly attractive, particularly to commercial entities. FDIC-insured depository institutions, including ILCs, are currently prohibited from offering interest-bearing business checking accounts. Recent legislative proposals would remove the current prohibition on paying interest on demand deposits and allow insured depository institutions, including all or some ILCs, to offer interest-bearing business NOW checking accounts. This would, in effect, expand the

[7]Unitary thrift holding companies are generally any company that owns a single thrift. Merchant banking refers to the practice where a financial institution makes a passive equity investment in a corporation with a view toward working with company management and operating partners to enhance the value of the equity investment over time. Federal banking law contains several provisions that are designed to distinguish merchant banking investments from the more general mixing of banking and commerce.

availability of products and services that insured depository institutions, including most ILCs, could offer. ILC advocates we spoke with stated that including ILCs in these legislative proposals maintains the current relative parity between ILC permissible activities and those of other insured bank charters. However, Board officials, as well as some industry observers we spoke with, told us that granting grandfathered ILCs the ability to pay interest on business NOW accounts represents an expansion of powers for ILCs, which, they stated, could further blur the distinction between ILCs and traditional banks. Another recent legislative proposal would allow banks and most ILCs (those included in a grandfather provision) to de novo branch by removing states' authority to prevent them from doing so. Board officials we spoke with told us that, if enacted, these proposals could increase the attractiveness of owning an ILC, especially by private sector financial or commercial holding companies that already operate existing retail distribution networks.

To better ensure that supervisors of institutions with similar risks have similar authorities, we are asking Congress to consider various options such as eliminating the current exclusion for ILCs and their holding companies from consolidated supervision, granting FDIC similar examination and enforcement authority as a consolidated supervisor, or leaving the oversight responsibility of small, less complex ILCs with the FDIC, and transferring oversight of large, more complex ILCs to a consolidated supervisor. In addition, we are asking Congress to more broadly consider the advantages and disadvantages of mixing banking and commerce to determine whether continuing to allow ILC holding companies to engage in this activity significantly more than the holding companies of other types of financial institutions is warranted or whether other entities should be permitted to engage in this level of activity.

We provided a draft of this report to the Board, FDIC, OTS, and SEC for review and comment. Each of these agencies provided technical comments that were incorporated as appropriate. In written comments, the Chairman of the Board of Governors of the Federal Reserve System (see app. II) concurred with the report's findings and conclusions and stated that "consolidated supervision provides important protections to the insured banks that are part of a larger organization, as well as the federal safety net that supports those banks" and that the report "properly highlights the broad policy implications that ILCs raise with respect to maintaining the separation of banking and commerce." In written comments from the Chairman of the Federal Deposit Insurance Corporation (see app. III), FDIC concurred that from an operations standpoint, ILCs do not appear to

have a greater risk of failure than other types of insured depository institutions but generally believed that no changes were needed in its supervisory approach over ILCs and their holding companies and disagreed with the matters for congressional consideration. Specifically, FDIC's disagreements generally focused on three primary areas—whether consolidated supervision of ILC holding companies is necessary to ensure the safety and soundness of the ILC; that FDIC's supervisory authority may not be sufficient to effectively supervise ILCs and insulate insured institutions against undue risks presented by external parties; and the impact that consolidated supervision of ILCs and their holding companies would have on the marketplace and the federal safety net. However, we believe that consolidated supervision offers broader examination and enforcement authorities that may be used to understand, monitor, and when appropriate, restrain the risks associated with insured depository institutions in a holding company structure. We continue to be concerned that FDIC's bank-centric approach has only been tested on a limited basis in relatively good economic times, and our report identifies additional tools that consolidated supervisors may use to help ensure the safety and soundness of insured depository institutions. Further, the report does not advocate an expansion of the federal safety net. Rather, this report advocates that ILCs and their holding companies be regulated in a similar manner as other insured depository institutions and their holding companies.

Background

Today, five federal agencies oversee federally insured depository institutions and consolidated supervised entities: Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and the National Credit Union Association. Many of those institutions are state chartered and are subject to state regulation. The specific regulatory configuration depends on the type of charter the banking institution chooses—commercial bank, thrift, credit union, or industrial loan company. To achieve their safety and soundness goals, bank regulators establish capital requirements, conduct on-site examinations and off-site monitoring to assess a bank's financial condition, and monitor compliance with banking laws. Regulators also issue regulations, take enforcement actions, and close banks they determine to be insolvent. In addition, federal regulators oversee compliance with and enforce consumer protection laws such as those requiring fair access to banking services and privacy protection.

The FDIC was created as an independent agency in 1933 to preserve and promote public confidence in the financial system by (1) insuring deposits in banks and thrift institutions for up to certain amounts (currently $100,000); (2) identifying, monitoring, and addressing risks to the Fund; and (3) limiting the effect on the economy and the financial system when a bank or thrift institution fails. Today, FDIC directly examines and supervises 5,272 insured, state-chartered banks, which, according to FDIC, is more than half of all institutions in the banking system. FDIC is the primary federal supervisor of state-chartered institutions that do not join the Federal Reserve System, including ILCs. In addition, FDIC is the backup supervisor for the remaining insured banks and thrift institutions. As of December 31, 2004, 3 of the top 16 largest insured institutions supervised by FDIC were ILCs. ILCs are also monitored at the state level and are subject to state and federal supervision in the same manner as state nonmember banks.

The Board was founded by Congress in 1913 and currently has the following four general areas of responsibility: (1) conducting the nation's monetary policy by influencing the money and credit conditions in the economy in pursuit of full employment and stable prices; (2) supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers; (3) maintaining the stability of the financial system and containing systemic risk that may arise in financial markets; and (4) providing certain financial services to the government, the public, financial institutions, and foreign official institutions, including playing a major role in operating the nation's payments system. Today, the Board is the primary supervisor of 919 state-chartered member banks and 5,863 bank holding companies, and has direct oversight of bank holding companies and their affiliates.

The Office of the Comptroller of the Currency (OCC), established in 1863 as a bureau of the Department of the Treasury (Treasury), is responsible for chartering, supervising, and regulating all national banks. OCC's mission is to ensure a stable and competitive national banking system through (1) ensuring the safety and soundness of the national banking system; (2) fostering competition by allowing banks to offer new products and services; (3) improving the efficiency and effectiveness of OCC supervision, including reducing regulatory burden; and (4) ensuring fair and equal access to financial services for all Americans. OCC also supervises the federal branches and agencies of foreign banks. Currently, OCC supervises 1,906 national banks.

OTS was established as a bureau of the Treasury in 1989. Its mission is to supervise savings associations and their holding companies in order to maintain their safety and soundness and compliance with consumer laws and to encourage a competitive industry that meets America's financial services needs. OTS is the primary federal supervisor of all federally chartered and many state-chartered thrift institutions, which includes savings banks and savings and loan associations. Currently, OTS regulates and supervises 886 thrifts[8]—some of which, like ILCs, are owned by a commercial holding company—and has direct oversight of the thrift, the thrift holding company and its subsidiaries, and its affiliates.

The National Credit Union Administration (NCUA) is an independent federal agency that charters and supervises federal credit unions and operates the National Credit Union Share Insurance Fund, which insures the savings in all federal and many state-chartered credit unions. Currently, NCUA regulates and supervises 9,128 credit unions.

In addition, the Securities and Exchange Commission has consolidated supervisory oversight of certain financial conglomerates, known as consolidated supervised entities, which are large, internationally active securities firms. Certain of these consolidated supervised entities own one or more large ILCs, although their primary line of business is the global securities market.

Bank Holding Companies

The BHC Act of 1956, as amended, contains a comprehensive framework for the supervision of bank holding companies and their nonbank subsidiaries. Bank holding companies are companies that own or control an FDIC-insured bank or other depository institution that meets the definition of "bank" in the BHC Act. Generally, any company that acquires control of an insured bank or bank holding company is required to register with the Board as a bank holding company. Regulation under the BHC Act

[8]We use the term thrift to refer to savings and loan associations. According to OTS, these institutions provide various financial services to consumers and small to mid-sized businesses in their communities and offer an array of deposit instruments including checking, savings, money market, and time deposits. Thrifts' lending activities are primarily focused on residential lending, including first mortgage loans, home equity loans, and loans secured by multifamily residences. They also provide loans for other consumer needs such as for autos, education, and home improvements. In addition, thrifts provide community businesses with working capital loans, loans secured by commercial property, and construction loans.

entails, among other things, consolidated supervision of the holding company by the Board, as well as restrictions on the activities of the holding company and its affiliates to those activities that are closely related to banking or, for qualified financial holding companies, activities that are financial in nature. The BHC Act defines "control" of an insured bank flexibly to include ownership or control of blocs of stock, the ability to elect a board majority, or other management control.[9] The Board's bank holding company supervision manual states that a bank holding company structure may offer advantages. For example, a bank holding company structure allows entities to avoid some regulatory constraints such as limitations on geographic areas they can serve. In addition, a bank holding company structure may increase an organization's financial flexibility by allowing the combined firm to avoid selected restrictions on the types of assets acquired, and types of liabilities that can be issued by the combined entity.

The Board's bank holding company supervision manual states that the holding company structure can adversely affect the financial condition of a bank subsidiary through exposing the bank to various types of risk. The reasons these risks occur cover a variety of circumstances, including poor risk management, poor bank management, and poor asset quality. For example, a holding company or its subsidiary with poor risk management procedures may take on excessive investment or market risks and fail. This failure of the holding company or affiliate can impair the insured institution's access to financial markets. In another example, a holding company with a poorly managed bank can initiate adverse intercompany transactions with the insured bank or impose excessive dividends on the insured bank.[10] Adverse intercompany transactions may include charging

[9]Any one of the following circumstances will trigger coverage by the BHC Act: (1) *Stock ownership* – Where the company owns, controls or has the power to vote 25 percent or more of any class of the voting securities of a bank or bank holding company (either directly or indirectly or acting through one or more other persons); (2) *Ability to elect a board majority*–Where the company controls the election of a majority of the directors or trustees of a bank or bank holding company; or (3) *Effective control of management*- Where the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of a bank or bank holding company. For purposes of this last provision, Congress expressly presumed that any company that directly or indirectly owns, controls, or has power to vote fewer than 5 percent of any class of voting securities of a specific bank or bank holding company does not have the requisite control. See 12 U.S.C. § 1841(a).

[10]As discussed more fully later in this report, federal law restricts transactions between an insured depository institution and its bank holding company affiliates.

above market prices for products or services, such as information technology (IT) services, provided to the insured institution by an affiliate or requiring the insured institution to purchase poor quality loans at above market prices from an affiliate. Such loans may place the insured institution at higher risk of loss. Other types of risk that holding companies and affiliates can pose to insured institutions include operations or reputation risks. Operations risk is the potential that inadequate information systems, operations problems, breaches in internal controls, or fraud will result in unexpected losses. From a practical standpoint, insured depository institutions, including ILCs, may be susceptible to operations risk when they are dependent on or share in the products or services of a holding company or its subsidiaries, such as IT services or credit card account servicing. If these entities ceased their operations, there could be an adverse impact on the insured institution. Reputation risk is the potential that negative publicity regarding an institution's or affiliate's business practices, whether true or not, could cause a decline in the customer base, costly litigation, or revenue reductions. Operations or reputation risks that impact the holding company can also affect affiliates throughout the corporate structure.

The Board's Regulation Y contains a provision stating that a bank holding company shall serve as a source of strength to its subsidiary banks and shall not conduct its operations in an unsafe and unsound manner.[11] According to the Board, as part of this policy, a bank holding company should stand ready to use its available resources to provide adequate funds to its subsidiary bank during periods of financial stress or adversity and should maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting its affiliate. According to this doctrine, a bank holding company should not withhold financial support from an affiliate bank in a weakened or failing position when it is in a position to provide the support. According to the Board, a bank holding company's failure to assist a troubled or failing subsidiary bank would generally be considered an unsafe and unsound practice and may result in a violation of Regulation Y. Consequently, such a failure would generally result in a cease and desist order or other enforcement action as authorized under banking law.

[11] 12 C.F.R. § 225.4 (2004).

Historical Policies Governing Separation of Banking and Commerce

The policy separating banking and commercial activity was first codified in provisions of the Banking Act of 1933 that generally are referred to as the Glass-Steagall Act. Glass-Steagall was largely a reaction to the perception that banks, and in particular banks that were part of larger conglomerate organizations, such as the J. P. Morgan and John D. Rockefeller entities of the era, wielded a disproportionate amount of economic power in the period leading up to the stock market crash of 1929. Among other things, Glass-Steagall generally prohibited banks from owning corporate stock for their own accounts and also limited affiliations between banks and securities firms. An immediate outcome of Glass-Steagall was that the Morgan, Rockefeller, and other complex business combinations with financial firms of the period were split into separate banking and nonbanking parts. Since then, Congress and banking supervisors have generally reaffirmed the long-standing policy of separating banking and commerce. For example, the BHC Act of 1956 generally prohibited bank holding companies from owning or controlling entities that were not banks unless, among other things, the Board determined that the entity's activities were "so closely related to the business of banking . . . as to be a proper incident thereto. . . ."[12] In 1970, Congress amended the BHC Act to broaden the Board's authority to determine when an activity is sufficiently related to banking but restricted bank holding companies to the business of banking remained a controlling principle of the act.[13] In 1999, the GLBA amended the BHC Act by, among other things, relaxing the distinction between separating banking and commerce to permit qualified bank holding companies—known as financial holding companies—to engage in a wider range of financial activities, such as insurance underwriting and securities brokerage. By restricting bank holding companies to activities that are financial in nature, GLBA generally reaffirmed the separation of banking from nonfinancial, commercial industries. In addition, in the GLBA, Congress also ended the unitary thrift provision that allowed commercial firms to acquire control of a single savings association.

[12]Bank Holding Company Act of 1956, Pub. L. No. 84-511 § 4.

[13]See Board of Governors of the Federal Reserve System v. Investment Company Institute, 450 U.S. 46, 72, n. 51 (1980).

ILCs Have Grown Significantly and Are No Longer Small, Limited Purpose Institutions

ILCs began in the early 1900s as small, state-chartered loan companies that served the borrowing needs of industrial workers that were unable to obtain noncollateralized loans from commercial banks. Since then, the ILC industry has experienced significant asset growth and has evolved from small, limited purpose institutions to a diverse group of insured financial institutions with a variety of business models. Most notably, from 1987 to 2004, ILC assets have grown over 3,500 percent from $3.8 billion to over $140 billion, while the number of ILCs declined about 46 percent from 106 to 57. In 2004, 6 ILCs were among the 180 largest financial institutions in the nation with $3 billion or more in total assets, and one institution had over $66 billion in total assets. During this time period, most of the growth occurred in the state of Utah while the portion of ILC assets in other states declined—especially in California. According to Utah officials, ILCs grew in that state because its laws are "business friendly," and the state offers a large, well-educated workforce for the financial services industry. Some ILCs have evolved into large, complex financial institutions with extensive access to capital markets.

ILCs Have Evolved Over Time

ILCs, also known as industrial banks, are state-chartered financial institutions that emerged from the Morris Plan banks of the early 20th century to provide consumer credit to low and moderate income workers. Generally, these workers were unable to obtain noncollateralized consumer loans from commercial banks. Since many state laws prevented these banks from accepting deposits, the banks issued certificates of investment or indebtedness often referred to as thrift certificates and avoided using the term "deposit." Initially, the FDIC determined that ILCs were not eligible to be insured.

Over time, FDIC policy regarding ILC's eligibility for deposit insurance changed. Insurance was initially granted on a case by case basis. However, the Garn-St. Germain Depository Institutions Act of 1982 made all ILCs eligible for federal deposit insurance.[14] This act also authorized federal deposit insurance for thrift certificates, a primary funding source for ILCs at the time.[15] Subsequently, some states required ILCs to obtain FDIC insurance as a condition of keeping their charters. As a result, FDIC

[14]Depository Institutions Act of 1982, Pub. L. No. 97-320 § 703.

[15]*Id.*

insured most ILCs, and they were subject to safety and soundness supervision by the FDIC in addition to the supervision they received from their respective states.

In 1987, Congress passed the Competitive Equality Banking Act (CEBA), which also impacted the ILC industry.[16] One purpose of CEBA was to close a provision in the BHC Act under which commercial firms were able to own "nonbank banks." These institutions had some characteristics of banks but did not meet the BHC Act's definition of a bank. Prior to CEBA, the BHC Act defined "bank" to mean an institution that both accepted demand deposits and engaged in the business of making commercial loans. Nonbank banks generally were limited purpose institutions that did not both accept demand deposits and make commercial loans. By avoiding the BHC Act definition of a bank, commercial firms that owned or controlled those institutions were able to provide certain banking services across state lines. Additionally, these firms were not subject to supervision by the Board as a bank holding company. CEBA prohibited new nonbank banks and more stringently defined "banks" under the BHC Act to include institutions insured by the FDIC. This new definition of a "bank" contained exceptions that allow entities that own or control certain types of insured institutions to avoid Board regulation as a bank holding company. One of these exceptions applies to ILCs chartered in states that on March 5, 1987, had in effect or under consideration a statute requiring ILCs to be FDIC insured. An ILC chartered in those states is exempt from the definition of "bank" in the BHC Act if it satisfies one or more of the following conditions:[17]

- The ILC does not accept demand deposits that may be withdrawn by check or similar means for payment to third parties.
- The ILC has total assets of less than $100 million.

[16] Pub. L. No. 100-86.

[17] 12 U.S.C. § 1841(c)(2)(H). According to the FDIC, at the time of the 1987 CEBA exemption six states—California, Colorado, Hawaii, Minnesota, Nevada, and Utah—had statutes in effect or under consideration requiring their ILCs to have federal deposit insurance. However, because the exemption for ILCs is in the BHC Act, the Board has primary responsibility for determining which states are grandfathered by the BHC Act. Only ILCs chartered in "grandfathered" states are eligible for the ILC exemption from the BHC Act.

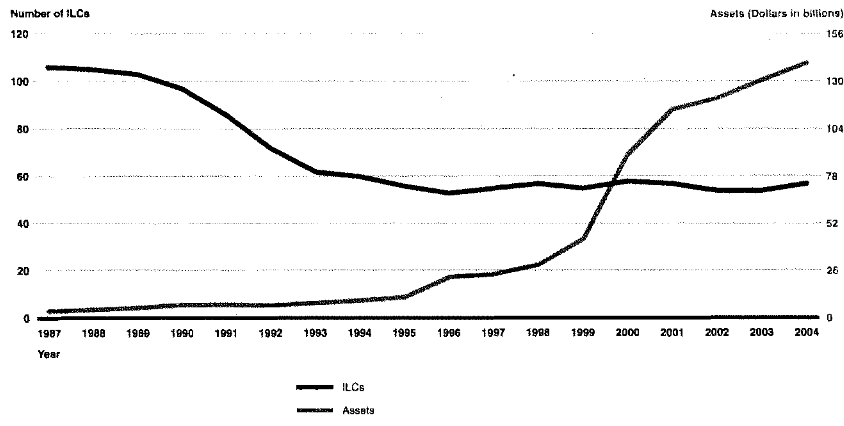
- Control of the ILC was not acquired by any company after August 10, 1987.

Since the passage of CEBA, the ILC industry has changed significantly and is currently a diverse group of insured financial institutions with a variety of business models. The majority of the 57 active ILCs, as of December 31, 2004, are owned and operated by financial services firms, such as the ILCs owned by Merrill Lynch, USAA Savings Bank, and American Express. These ILCs are complex financial institutions with extensive access to capital markets. Other ILCs are part of a business organization whose activities are conducted within the financial arm of a larger corporate organization that is not necessarily financial in nature, such as the ILCs owned by GE Capital Financial and GMAC Commercial Mortgage Bank. In addition, other ILCs directly support the holding company organizations' commercial activities, such as the ILCs owned by BMW and Volkswagen. Additionally, some ILCs are smaller, community-focused, stand-alone institutions such as Golden Security Bank and Tustin Community Bank.

ILCs Have Experienced Significant Asset Growth

The total assets of the ILC industry have increased significantly since 1987. As shown in figure 1, although the total number of ILCs has decreased by nearly half, from 106 to 57, as of December 31, 2004, the total assets in the ILC industry have grown by over 3,500 percent, increasing from $3.8 billion in 1987 to over $140 billion in 2004. In 2004, 6 ILCs were among the 180 largest financial institutions in the nation with $3 billion or more in total assets, and one institution had over $66 billion in assets. This significant growth in ILC assets was primarily concentrated in a few large ILCs owned by financial services firms. For example, as of December 31, 2004, 6 ILCs owned 85 percent of the total assets for the ILC industry with aggregate assets totaling over $119 billion and collectively controlled about $64 billion in FDIC-insured deposits.

Figure 1: Number and Total Assets of ILCs



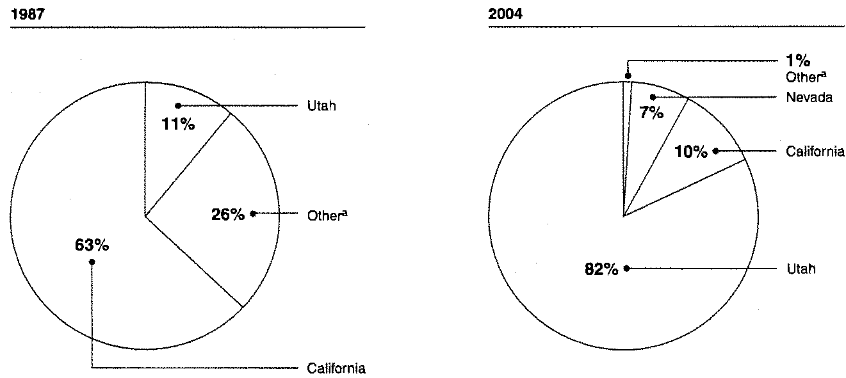
Source: GAO analysis of FDIC Call Report data.

Today, the vast majority of ILC assets are located in California, Nevada, and Utah. Although seven states have active ILCs, three states charter more than half, or 49, of the active ILCs that own over 99 percent of the ILC industry's assets, as shown by figure 2. The state of Utah has experienced the largest amount of ILC asset growth. As of December 31, 2004, there were 29 ILCs, representing 82 percent of the ILC industry assets, with headquarters in Utah. According to officials at the Utah Department of Financial Institutions, ILC growth in Utah occurred because other state laws are not as "business friendly" as Utah. These officials also stated that Utah has state usury laws that are more desirable than many other states, and the state offers a large well-educated workforce for the financial institutions industry.

Figure 2 also shows that the portion of ILC assets in states other than Utah declined significantly. Moreover, California had the largest decline in the number of ILCs during this time period. According to state banking

regulators in California, the decline in the number of ILCs was partially due to a state law passed in 1985 requiring all thrifts and loans, including ILCs, to obtain federal insurance in order to accept deposits. Because many ILCs were unable to get approval from FDIC, they were liquidated. Another reason these officials gave for the decline in ILCs in California was that the ILC industry in California experienced similar failures as the banking and savings and loan industries in the late 1980s and early 1990s. While these failures and law changes accounted for much of the decline in the assets held by California ILCs, these officials also stated that California's laws are less favorable to business, which may also have restricted the growth of the ILC industry in that state.

Figure 2: Percentage of ILC Assets Held by Individual States



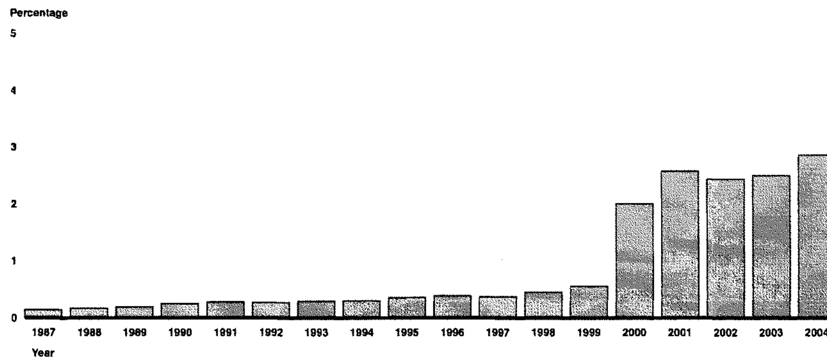
Source: GAO analysis of FDIC Call Report data.

[a]The other category may consist of as many as nine states in some years. In 1987, states in this category included Arizona, Colorado, Florida, Hawaii, Minnesota, Nebraska and West Virginia. In 2004, this category included Colorado, Hawaii, and Minnesota.

Figure 3 shows that, although the total amount of estimated insured deposits in the ILC industry has grown by over 500 percent since 1999, these deposits represent less than 3 percent of the total estimated insured

deposits in the bank insurance fund for all banks. The significant increase in estimated insured deposits since 1999 was related to the growth of a few ILCs owned by financial services firms. For example, at the end of 2004, the largest ILC, owned by an investment bank, had over $40 billion in FDIC insured deposits.

Figure 3: Percentage of Estimated FDIC Insured Deposits Held by ILCs



Source: GAO analysis of FDIC Call Report data.

ILC Business Lines and Regulatory Safeguards Are Similar to Other Insured Financial Institutions

Federal banking law permits FDIC-insured ILCs to engage in the same activities as other insured depository institutions. However, because of restrictions in California state law and in order to qualify for exemption from the BHC Act, most ILCs, which are owned by non-BHC Act holding companies, may not accept demand deposits. Banking laws in California, Nevada, and Utah have undergone changes that generally place ILCs on par with traditional banks. Thus, like other FDIC-insured depository institutions, ILCs may offer a full range of loans such as consumer, commercial and residential real estate, and small business loans. Further, like a bank, ILCs may "export" their home-state's interest rates to customers residing elsewhere. In addition, ILCs generally are subject to the

same federal regulatory safeguards that apply to commercial banks and thrifts, such as federal restrictions governing transactions with affiliates and laws addressing terrorism, money laundering, and other criminal activities by bank customers.

ILCs Are Permitted to Engage in Most Banking Activities

Under the Federal Deposit Insurance Act (FDI Act), FDIC insured institutions, including ILCs, generally are permitted to engage only in activities as principal that are permissible for a national bank, although the FDIC may approve of an additional activity if it determines that the activity would pose no significant risk to the bank insurance fund (Fund), and the institution complies with applicable federal capital standards. During our review, we did not identify any banking activities that were unique to ILCs that other insured depository institutions were not permitted to do. Table 1 shows that, like other insured depository institutions, ILCs are permitted to offer a wide variety of loans including consumer, commercial and residential real estate, small business, and subprime.[18] Like other FDIC-insured state charters, an ILC may charge its customers the interest rates allowed by the laws of the state where the ILC is located, no matter where the customers reside.[19] In effect, this permits ILCs offering credit cards to charge their state's maximum allowable interest rates in other states.[20] A primary difference between ILCs and other FDIC-insured depository institutions is that, to remain exempt from the BHC Act, ILCs must be chartered in the grandfathered states and generally do not accept demand deposits if their total assets are $100 million or more.

[18]Subprime loans are a type of lending that relies on risk-based pricing to serve borrowers who cannot obtain credit in the prime market.

[19]See 12 U.S.C. § 1831d(a); see also, FDIC General Counsel's Opinion No. 11, Interest Charges by Interstate State Banks, 63 Fed. Reg. 27282 (May 18, 1998).

[20]Nevada and Utah do not cap the interest rates credit card companies can charge. Their usury laws, similar to Delaware and South Dakota, are considered desirable for credit card entities.

Table 1: Comparison of Permissible Activities Between State Nonmember Commercial Banks and ILCs in a Holding Company Structure

Permissible activities	State nonmember commercial bank	Industrial loan corporation
Ability to offer full range of loans, including: consumer, commercial real estate, residential real estate, small business, and subprime.	Yes	Yes
Ability to export interest rates.	Yes	Yes
Ability to offer full range of deposits including demand deposits.	Yes	Yes, except in California. However, BHC Act-exempt ILCs may offer demand deposits if either the ILC's assets are less than $100 million or the ILC has not been acquired after August 10, 1987.

Source: FDIC.

Note: This table was adapted from FDIC's *Supervisory Insights*, Summer 2004. According to the FDIC officials, *Supervisory Insights* was published in June 2004, by FDIC to provide a forum to discuss how bank regulation and policy is put into practice in the field, share best practices, and communicate emerging issues that bank supervisors are facing. This inaugural issue described a number of areas of current supervisory focus at the FDIC, including the ILC charter. According to FDIC officials, *Supervisory Insights* should not be construed as regulatory or supervisory guidance.

As discussed previously, in order to maintain an exemption from the BHC Act, most ILCs with assets of $100 million or more may not accept demand deposits that the depositor may withdraw by check or similar means for payment to third parties. Representatives from some ILCs told us that because demand deposits are an important, often primary source of cost-effective funding for some depository institutions, restrictions on ILCs' ability to accept demand deposits is a limitation of the ILC charter. However, federal regulation does not restrict ILCs' use of NOW accounts. NOW accounts are similar to demand deposits but give the depository institution the right to require at least 7 days written notice prior to withdrawal. In addition, NOW accounts can be FDIC insured. Some ILCs use NOW accounts as a source of funding, particularly those institutions owned by investment banking/brokerage firms. Further, some ILCs finance

their operations through sources other than FDIC insured deposits and use commercial paper, brokered deposits.[21]

Based on an analysis of the permissible activities of ILCs and other insured depository institutions, we and the FDIC-IG found that, from an operations standpoint, ILCs do not appear to have a greater risk of failure than other types of insured depository institutions. FDIC officials have reported that, like other insured depository institutions, the risk of failure and loss to the deposit insurance fund from ILCs is not related to the type of charter the institution has. Rather, these officials stated that this risk depends on the institution's business plan and the type of business that the entity is involved in, management's competency to run the bank, and the quality of the institution's risk-management process. Further, FDIC officials stated that FDIC's experience does not indicate that the overall risk profile of ILCs is different from that of other types of insured depository institutions, and ILCs do not engage in more complex transactions than other institutions.

Some State Banking Laws Have Evolved to Make ILCs More Like Banks

Despite initial state limitations on certain permissible activities of ILC charters, the laws of the states we reviewed have essentially placed ILCs on par with other FDIC-insured state banks. For example, officials in California told us that ILCs originally were chartered to serve various niche lending markets. However, these officials stated that, over time, changes were made to California laws governing ILCs because these entities sought to be more competitive with other financial institutions and engage in different types of lending activities not specified in the charter law. According to these officials, in October of 2000, the California legislature revised the ILC charter law that contained a variety of outdated and artificial lending restrictions. California officials also stated that, at that time, ILCs were brought under the state banking laws and, with the exception of the restriction against accepting demand deposits, ILCs became subject to the same laws and regulations, as well as standards for safe and sound lending practices, as commercial banks. According to these officials, the laws that were no longer applicable to ILCs contained restrictions on, among other things, the

[21]Commercial paper generally is a short-term, unsecured promissory note issued primarily by highly rated corporations. Many companies use commercial paper to raise cash needed for current transactions and find it to be a lower-cost alternative to bank loans. Brokered deposits are generally deposits obtained by a deposit broker and are considered rate-sensitive because consumers are able to withdraw them quickly and without notice.

- type of security for an ILC loan,
- amount of loans that could be made out-of-state,
- loan-to-value ratios on loans,[22] and
- amount of loans that had to be collateralized by real estate.

Officials at the Utah Department of Financial Institutions (Utah DFI) told us that, since 1985, ILCs chartered in Utah have generally been able to conduct the same permissible activities as state chartered commercial banks. In addition, since at least 1997, Utah ILCs have been permitted to use the term "bank" in their name.

ILCs Must Comply with Federal Requirements Applicable to Other Insured Institutions

ILCs are subject to federal safety and soundness safeguards and consumer protection laws that apply generally to FDIC-insured institutions. These include restrictions on transactions between an insured institution and its affiliates under sections 23A and 23B of the Federal Reserve Act that are designed to protect the insured depository institution from adverse transactions with holding companies and affiliates. Sections 23A and 23B generally limit the dollar amount of loans to affiliates and require transactions to be done on an "arms-length" basis.[23] Specifically, section 23A regulates "covered transactions" between a bank and its affiliates and permits an institution to conduct these transactions with its affiliates so long as the institution limits the aggregate amount of covered transactions with a particular affiliate to not more than 10 percent of the bank's capital stock and surplus and, with all of its affiliates, to 20 percent of the

[22]Loan-to-value ratios are a lending risk ratio calculated by dividing the total amount of the mortgage loan by the appraised value of the property or the purchase price of the property.

[23]Section 18(j) of the FDI Act extends the provisions of sections 23A and 23B of the Federal Reserve Act to state nonmember banks. 12 U.S.C. § 1828(j).

institution's capital stock and surplus.[24] Section 23B essentially imposes the following four restrictions: (1) a requirement that the terms of affiliate transactions be comparable to terms of similar nonaffiliate transactions; (2) a restriction on the extent that a bank may, as a fiduciary, purchase securities and other assets from an affiliate; (3) a restriction on the purchase of securities where an affiliate is the principal underwriter; and (4) a prohibition on agreements and advertising providing or suggesting that a bank is responsible for the obligations of its affiliates.

Examples of other regulatory safeguards that ILCs must comply with include provisions of the following Board regulations:

- Regulation O, which governs the extension of credit by a depository institution to an executive officer, director, or principal shareholder of the institution;[25]
- Regulation D, which sets reserves a depository institution must hold against deposits;[26]
- Regulation Q, which generally prohibits the payment of interest on demand deposits;[27] and
- Regulation F, which requires that banks establish policies and procedures to prevent excessive exposure to any individual correspondent bank.[28]

[24]Covered transactions are specifically described in section 23A (b)(7)(A) through (E) but generally consist of making loans to an affiliate; purchasing securities issued by an affiliate; purchasing nonexempt assets from an affiliate; accepting securities issued by an affiliated company as collateral for any loan; and issuing a guarantee, acceptance, or letter of credit on behalf of (for the account of) an affiliate. Section 23A also lists several types of transactions that are specifically exempted from its provisions. Under the BHC Act, as amended by GLBA, a depository institution controlled by a financial holding company is prohibited from engaging in covered transactions with any affiliate that engages in nonfinancial activities under the special 10-year grandfather provisions in the GLBA. 12 U.S.C. § 1843 (n)(6).

[25]See 12 C.F.R. § 337.3 (2005).

[26]See 12 C.F.R. Part 204.

[27]See 12 C.F.R. Part 329.

[28]See 12 C.F.R. Part 206.

In addition to these safeguards, ILCs must also comply with Bank Secrecy Act, Anti-Money Laundering, and Community Reinvestment Act requirements. Further, ILCs, like other insured depository institutions, are subject to consumer protection laws and must comply with federal regulations such as the Board's

- Regulation B, which implements the Equal Credit Opportunity Act's antidiscrimination provisions;[29]
- Regulation Z, which implements the Truth in Lending Act requirements relating to disclosures and other consumer protections;[30] and
- Regulation CC, which implements the Expedited Funds Availability Act, including the Act's requirements regarding the limits on the length of time that a hold may be placed on funds deposited into an account, including a NOW account.[31]

FDIC's Supervisory Authority Over ILC Holding Companies and Affiliates Is Not Equivalent to Consolidated Supervisors' Authority

Because most ILCs exist in a holding company structure, they are subjected to risks from the holding company and its subsidiaries, including adverse intercompany transactions, operations, and reputation risk, similar to those faced by banks and thrifts existing in a holding company structure. However, FDIC's authority over the holding companies and affiliates of ILCs is not as extensive as the authority that consolidated supervisors have over the holding companies and affiliates of banks and thrifts. For example, FDIC's authority to examine an affiliate of an insured depository institution exists only to disclose the relationship between the depository institution and the affiliate and the effect of that relationship on the depository institution. Therefore, any reputation or other risk from an affiliate that has no relationship with the ILC could go undetected. In contrast, consolidated supervisors, subject to functional regulation restrictions, generally are able to examine a nonbank affiliate of a bank or thrift in a holding company regardless of whether the affiliate has a relationship with the bank. FDIC officials told us that with its examination authority, as well as its abilities to impose conditions on or enter into agreements with an ILC holding

[29]See 12 C.F.R. Part 202.

[30]See 12 C.F.R. Part 226.

[31]See 12 C.F.R. Part 229.

company in connection with an application for federal deposit insurance, terminate an ILC's deposit insurance, enter into agreements during the acquisition of an insured entity, and take enforcement measures, FDIC can protect an ILC from the risks arising from being in a holding company as effectively as with the consolidated supervision approach. However, we found that, with respect to the holding company, these authorities are limited to particular sets of circumstances and are less extensive than those possessed by consolidated supervisors of bank and thrift holding companies. As a result, FDIC's authority is not equivalent to consolidated supervision of the holding company.

FDIC and Consolidated Supervisors Use Different Supervisory Approaches

With some exceptions, companies that own or control FDIC insured depository institutions are subject to a consolidated—or top-down—supervisory approach that is aimed at assessing the financial and operations risks within the holding company structure that may pose a threat to the safety and soundness of the depository institution. Consolidated supervision is widely recognized throughout the world, including Asia, Europe, and in North America, as an accepted approach to supervising organizations that own or control financial institutions and their affiliates. The European Union also requires consolidated supervision for financial institutions operating in its member states, and this approach is recognized by the Basel Committee as an essential element of banking supervision.[32] According to this committee, consolidated supervision "includes the ability to review both banking and nonbanking activities conducted by the banking organization, either directly or indirectly (through subsidiaries and affiliates), and activities conducted at both domestic and foreign offices. Supervisors need to take into account that nonfinancial activities of a bank or group may pose risks to the bank. In all cases, the banking supervisors should be aware of the overall structure of the banking organization or group when applying their supervisory methods."

In contrast to the top-down approach of bank consolidated supervision, which focuses on depository institution holding companies, FDIC's

[32]The Basel Committee on Banking Supervision, established in 1974, is composed of representatives from the central banks or supervisory authorities of various countries in Europe, North America, and Asia. This committee has no formal authority but seeks to develop broad supervisory standards and promote best practices in the expectation that each country will implement the standards in ways most appropriate to its circumstances. Implementation is left to each nation's regulatory authorities.

supervision focuses on depository institutions. FDIC's authority extends to affiliates of depository institutions under certain circumstances, thus FDIC describes its approach to examining and taking supervisory actions concerning depository institutions and their affiliates (including holding companies), as bank-centric or bottom-up. According to FDIC officials, the objective of this approach is to ensure that the depository institution is insulated and isolated from risks that may be posed by a holding company or its subsidiaries. This objective is similar to the objectives of consolidated supervision. While FDIC officials assert that the agency's bank-centric approach can go beyond the insured institution, as discussed later in this report, this approach is not as extensive as the consolidated supervisory approach in assessing the risks a depository institution faces in a holding company structure.

Consolidated Supervisors Have More Explicit Supervisory Authority Over Holding Company Affiliates than FDIC

As consolidated supervisors, the Board and OTS have authority to examine bank and thrift holding companies and their nonbank subsidiaries in order to assess risks to the depository institutions that could arise because of their affiliation with other entities in a consolidated structure. The Board and OTS may examine holding companies and their nonbank subsidiaries, subject to some limitations,[33] to assess, among other things, the nature of the operations and financial condition of the holding company and its subsidiaries; the financial and operations risks within the holding company system that may pose a threat to the safety and soundness of any depository institution subsidiary of such a holding company; and the systems for monitoring and controlling such risks.[34] The Board's examination authority is limited to certain circumstances, such as where the Board "has reasonable cause to believe that such subsidiary is engaged in activities that pose a material risk to an affiliated depository institution" or the Board has determined that examination of the subsidiary is necessary to inform the Board of the systems the company has to monitor and control the financial and operational risks within the holding company system that may threaten the safety and soundness of an affiliated

[33]See 12 U.S.C. § 1831v(b).

[34]See 12 U.S.C. §§ 1844(c)(2)(A), 1467a.

depository institution.[35] OTS's examination authority with respect to holding companies is subject to the same limitation.[36] Also, the focus of Board and OTS examinations of all holding company nonbank subsidiaries must, to the fullest extent possible, be limited to subsidiaries that could have a materially adverse effect on the safety and soundness of a depository institution affiliate due to either the size, condition, or activities of the subsidiary or the nature or size of transactions between the subsidiary and any affiliated depository institution.[37] FDIC examinations of affiliates having a relationship with an institution are not subject to the same limitations where the examination is to determine the condition of the institution for insurance purposes.[38]

As a result of their authority, consolidated supervisors take a systemic approach to supervising depository institution holding companies and their nonbank subsidiaries. Consolidated supervisors may assess lines of business, such as risk management, internal control, IT, and internal audit across the holding company structure in order to determine the risk these operations may pose to the insured institution. These authorities enable consolidated supervisors to determine whether holding companies that own or control insured depository institutions, as well as holding company nonbank subsidiaries, are operating in a safe and sound manner so that their financial condition does not threaten the viability of their affiliated depository institutions.[39] Thus, consolidated supervisors can examine a holding company subsidiary to determine whether its size, condition, or activities could have a materially adverse effect on the safety and soundness of the bank even if there is no direct relationship between the two entities. Although the Board's and OTS's examination authorities are subject to some limitations, as previously noted, both the Board and OTS maintained that these limitations do not restrict the supervisors' ability to detect and assess risks to an insured depository institution's safety and

[35]See 12 U.S.C. § 1844(c)(2)(B).

[36]See 12 U.S.C. §§ 1467a(b)(4), 1831(a).

[37]See 12 U.S.C. §§ 1844(c)(2)(C), 1831v(a).

[38]See 12 U.S.C. § 1831v(b).

[39]See "Framework for Financial Holding Company Supervision," Letter from the Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, to the Officer in Charge of Supervision and Appropriate Supervisory Staff at Each Federal Reserve Bank and to Financial Holding Companies (August 15, 2000).

soundness that could arise solely because of its affiliations within the holding company.

The Board's and OTS' consolidated supervisory authorities also include the ability to require holding companies and their nonbank subsidiaries to provide reports in order to keep the agencies informed about matters that include the holding company's or affiliate's financial condition, systems for monitoring and controlling financial and operations risks, and transactions with affiliated depository institutions.[40] These authorities are subject to restrictions designed to encourage the agency to rely on reports made to other supervisors, publicly available information, and externally audited financial statements. The Board requires that bank holding companies provide annual reports of the company's operations for each year that it remains a bank holding company; OTS has the authority to require an independent audit of, among other things, the financial statements of a holding company, at any time.[41] According to Board's and OTS' examination manuals, examiners may also use additional reports of holding company and affiliate activities that are not publicly available, such as the holding company's financial statements, budgets and operation plans, various risk management reports, and internal audit reports.

In addition to examination authority, as consolidated supervisors, the Board and OTS have instituted standards designed to ensure that the holding company serves as a source of strength for its insured depository institution subsidiaries. The Board's regulations for bank holding companies include consolidated capital requirements that, among other things, can help protect against a bank's exposure to risks associated with its membership in the holding company.[42] The OTS does not impose consolidated regulatory capital requirements on thrift holding companies. Although there is no specific numerical requirement (ratio), OTS's policy is that regulated holding companies should have an adequate level of capital to support their risk profile. OTS examiners are instructed to consider all aspects of an organization's risk profile, on a case by case basis, to determine if capital is adequate with respect to both the holding company and its affiliate thrift.

[40]See 12 U.S.C. §§ 1844(c)(1), 1467a(b)(2), 1844(c)(1)(B), 1831v(a)(1).

[41]12 C.F.R. § 225.5(b) (Board); 12 C.F.R. § 562.4(a) (OTS).

[42]12 C.F.R. Part 225, Appendices B & C.

In addition to consolidated capital requirements, the Board has, by regulation, instituted the "source of strength" doctrine, which states that a bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks.[43] According to Board officials, the source of strength doctrine can be invoked to require a bank holding company to take affirmative action, for example, by providing capital infusions to an affiliate depository institution in financial distress, in order to enhance the safety and soundness of the institution. Some banking experts have expressed concern that the Board's authority to require a transfer of assets from the holding company to a troubled affiliate bank is unclear.[44] In amendments to the BHC Act and FDI Act enacted as part of GLBA, Congress indicated its understanding that the Board has such authority. These amendments refer to (1) limiting the Board's authority to require the transfer of funds or other assets to a subsidiary bank by bank holding companies or affiliates that are insurance companies or are registered as brokers, dealers, investment companies or investment advisers; (2) granting the Board authority to require a functionally regulated subsidiary of a holding company to provide capital or other funds or assets to a depository institution affiliate of the holding company; and (3) prohibiting a bank holding company from engaging in expanded activities as a financial holding company unless, among other things, all of its depository institutions are well capitalized.[45] The third of these provisions suggests that the Board has authority to order the holding company to maintain the bank's capital as a condition of its status as a financial holding company. OTS officials stated that OTS has the same authority as the Board with respect to requiring a capital infusion.

[43]See 12 C.F.R. § 225.4(a).

[44]The concern is based upon differing views about the effect of the Supreme Court's ruling in *Board of Governors v. MCorp. Financial, Inc.*, 502. U.S. 32 (1991). In *MCorp*, the Court reversed a federal circuit court's holding that federal courts had jurisdiction to consider and enjoin an administrative action by the Board alleging MCorp's violation of the Board's source of strength regulation. The Court observed that MCorp ultimately could seek judicial review of the validity of the source of strength regulation and its application "if and when the Board finds that MCorp has violated that regulation." 502 U.S. at 43-44. The judicial action subsequently was dismissed for lack of jurisdiction. *MCorp. Financial v. Board of Governors*, 958 F.2d 615 (5th Cir. 1992). Questions about the validity and enforcement of the regulation were unresolved.

[45]See, e.g., 12 U.S.C. §§ 1844(g), 1831v(a)(2), and 1843(l), respectively.

The Board and OTS also have enforcement authority over holding companies and their nonbank subsidiaries which, among other things, allows the agencies to order the termination of any activity, or ownership, or control of any noninsured subsidiary, if there is reasonable cause to believe that the continuation of the activity or ownership or control of the uninsured affiliate constitutes a serious risk to the financial safety, soundness, or stability of an affiliated insured depository institution. For example, if a subsidiary exposed the holding company to reputation risk that constituted a serious risk to the financial safety and soundness of an affiliated bank, these authorities could be used to force the holding company to divest of the subsidiary in order to prevent any negative impact from spreading to the insured institution.[46]

In contrast to the consolidated supervisory approaches of the Board and OTS, FDIC's authority does not specifically address the circumstances of an ILC holding company or its nonbank subsidiaries except in the context of a relationship between the ILC and an entity affiliated with it through the holding company structure. Specifically, FDIC's authority to examine state nonmember banks, including ILCs, includes the authority to examine some, but not all, affiliates of the ILC in a holding company structure. Under section 10(b) of the FDI Act, FDIC may, in the course of examining an institution, examine "the affairs of any affiliate of (the) institution as may be necessary to disclose fully—(i) the relationship between such depository institution and any such affiliate; and (ii) the effect of such relationship on the depository institution."[47] FDIC's use of this authority to determine the condition of an institution for insurance purposes is not limited by the functional regulation restrictions that apply to examinations by the Board and OTS.[48] Also, according to FDIC officials, FDIC can use its subpoena and other investigative authorities to obtain information from any affiliate, as well as any nonaffiliate, to determine compliance with applicable law and with respect to any matter concerning the affairs or

[46]See 12 U.S.C. § 1818(b)(3) (enforcement authority regarding nonbank subsidiaries includes authority to impose cease and desist orders for unsafe or unsound practices); see also, 12 U.S.C. § 1467(g) (OTS enforcement authority regarding thrift holding companies); 12 C.F.R. § 225.4(b) (Board regulation providing for divestiture of holding company affiliates); 12 U.S.C. § 1467a(g)(5) (OTS divestiture authority).

[47]See 12 U.S.C. 1820(b)(4)(A).

[48]See 12 U.S.C. 1831v(b).

ownership of an insured institution or any of its affiliates.[49] According to FDIC officials, such an investigation would be triggered by concerns about the insured institution.

Because FDIC does not regulate institutions affiliated with depository institutions on a consolidated basis, it has no direct authority to impose consolidated supervision requirements, such as capital levels and reporting obligations, on ILC holding companies. However, FDIC does have authorities that it can use for certain purposes to address risk to depository institutions in a holding company structure. For example, FDIC can initiate an enforcement action against an insured ILC and, under appropriate circumstances, an affiliate that qualifies as an institution-affiliated party (IAP) of the ILC if the ILC engages in or is about to engage in an unsafe or unsound practice.[50] An ILC affiliate is an IAP if, among other things, it is a controlling stockholder (other than a bank holding company), a shareholder who participates in the conduct of the affairs of the institution, or an independent contractor who knowingly or recklessly participates in any unsafe or unsound practices.[51] However, FDIC's ability to use this authority to, for example, hold an ILC holding company responsible for the financial safety and soundness of the ILC is less extensive than application of the source of strength doctrine by the Board or OTS under consolidated supervision. As we will discuss later, FDIC officials assert that FDIC can use its supervisory power over an ILC under certain circumstances to achieve similar results as under consolidated supervision.

Figure 4 compares some of the differences in explicit supervisory authority between FDIC and consolidated supervisors, specifically the Board and OTS. The table shows that in two of the eight areas FDIC has examination authority with respect to ILC affiliates that have a relationship with the ILC, as do the Board and OTS. However, we identified six areas where FDIC's explicit authority with respect to ILC holding company affiliates is not as extensive as the explicit authorities of consolidated supervisors to examine, impose capital-related requirements on, or take enforcement

[49]See 12 U.S.C. § 1820(c).

[50]FDIC has no authority to take action against an ILC affiliate whose activities weaken the holding company, and potentially the ILC, unless the affiliate is an IAP and the IAP participated in conducting the ILC's business in an unsafe or unsound manner, violated a legal requirement or written condition of insurance, or otherwise engaged in conduct subject to enforcement. See 12 U.S.C. § 1818(b).

[51]See 12 U.S.C. § 1813(u).

actions against holding companies and affiliates of an insured institution. In general, FDIC's supervisory authority over holding companies and affiliates of insured institutions depends on the agency's authority to examine certain affiliates and its ability to enforce conditions of insurance and written agreements, to coerce conduct based on the prospect of terminating insurance, and to take enforcement actions against a holding company or affiliate that qualifies as an IAP.[52]

Figure 4: Comparison of Explicit Supervisory Authorities of the FDIC, Board, and OTS

Description of explicit supervisory authority	FDIC[a]	Board	OTS
Examine the relationships, including specific transactions, if any, between the insured institution and its parent or affiliates.	●[b]	●[b]	●[b]
Examine beyond specific transactions when necessary to disclose the nature and effect of the relationship between the insured institution and the parent or affiliate.	●[b]	●[b]	●[b]
Examine the parent or any affiliate of an insured institution, including a parent or affiliate that does not have any relationships with the insured institution or concerning matters that go beyond the scope of any such relationships and their effect on the depository institution.	○	●[b]	●[b]
Take enforcement actions against the parent of an insured institution.	◒[b,c]	●[b]	●[b]
Take enforcement actions against affiliates of the insured institution that participates in the conduct of affairs of, or acts as agent for, the insured institution.	◒[b]	●[b]	●[b]
Take enforcement action against any affiliate of the insured institution, even if the affiliate does not act as agent for, or participate in the conduct of, the affairs of the insured institution.	○	●[b]	●[b]
Compel the parent and affiliates to provide various reports such as reports of operations, financial condition, and systems for monitoring risk.	◒[b,d]	●[b]	●[b]
Impose consolidated or parent-only capital requirements on the parent and require that it serve as a source of strength to the insured depository institution.	◒[d]	●	●
Compel the parent to divest of an affiliate posing a serious risk to the safety and soundness of the insured institution.	◒[e]	●	●

● Explicit authority

◒ Less extensive authority

○ No authority

Sources: GAO analysis of the supervisory authorities of the FDIC, Board, and OTS.

[a]FDIC may examine an insured institution for interaffiliate transactions at any time and can examine the affiliate when necessary to disclose the transaction and its effect on the insured institution.

[52]In addition to these authorities, we note that measures under the prompt corrective action provisions of the FDI Act based on an institution's undercapitalized status include a parental capital maintenance guarantee and the possibility of divestiture of a significantly undercapitalized depository institution or any affiliate. See 12 U.S.C. § 1831o. These measures apply equally to all FDIC insured institutions and their respective regulators.

[b]The authority that each agency may have regarding functionally regulated affiliates of an insured depository institution is limited in some respects. For example, each agency, to the extent it has the authority to examine or obtain reports from a functionally regulated affiliate, is generally required to accept examinations and reports by the affiliates' primary supervisors unless the affiliate poses a material risk to the depository institution or the examination or report is necessary to assess the affiliate's compliance with a law the agency has specific jurisdiction for enforcing with respect to the affiliate (e.g., the Bank Holding Company Act in the case of the Board). These limits do not apply to the Board with respect to a company that is itself a bank holding company. These restrictions also do not limit the FDIC's authority to examine the relationships between an institution and an affiliate if the FDIC determines that the examination is necessary to determine the condition of the insured institution for insuranca purposes.

[c]FDIC may take enforcement actions against institution-affiliated parties of an ILC. A typical ILC holding company qualifies as an institution-affiliated party. FDIC's ability to raquire an ILC holding company to provide a capital infusion to the ILC is limited. In addition, FDIC may take enforcement action against the holding company of an ILC to address unsafe or unsound practices only if the holding company engages in an unsafe or unsound practice in conducting the affairs of the depository institution.

[d]FDIC maintains that it can achieve this result by imposing an obligation on an ILC holding company as a condition of insuring the ILC. FDIC also maintains it can achieve this result as an alternative to terminating insurance. FDIC officials also stated that the prospect of terminating insurance may compel the holding company to take affirmative action to correct violations in order to protect the insurad institution. According to FDIC officials, there are no examples where FDIC has imposed this condition on a holding company as a condition of insurance.

[e]In addition to an enforcement action against the holding company of an ILC in certain circumstances (see footnote b), as part of prompt corrective action the FDIC may require any company having control over the ILC to (1) divest itself of the ILC if divestiture would improve the institution's financial condition and future prospects, or (2) divest a nonbank affiliate if the affiliate is in danger of becoming insolvent and poses a significant risk to the institution or is likely to cause a significant dissipation of the institution's assets or earnings. However, the FDIC generally may take such actions only if the ILC is already significantly undercapitalized.

While FDIC's Authority is Less Extensive Than Consolidated Supervision, FDIC Officials Assert Its Authority Could Achieve Similar Results

Although FDIC's authority over an insured ILC permits FDIC to take certain measures with respect to some ILC holding company affiliates under certain circumstances, this authority is not equivalent to consolidated supervision of the holding company. However, FDIC officials stated that it can adequately protect an ILC from the risks arising from being in a holding company without adopting a consolidated supervision approach. The officials stated that FDIC has various authorities, including the following:

- examining certain ILC affiliates that have a relationship with the ILC;
- imposing requirements on an ILC holding company in connection with an application for deposit insurance, as a condition of insuring the ILC;
- terminating deposit insurance or entering into written agreements with the holding company to correct conditions that would warrant termination of the ILC's insurance;

- obtaining written agreements from the acquiring entity in connection with a proceeding to acquire an ILC; and
- taking enforcement measures against ILCs and certain ILC affiliates.

FDIC may be able to use these authorities in many instances to supervise ILCs and their holding company and affiliates. However, because these authorities can be used in connection with concerns about a particular ILC only under specific circumstances, they do not provide FDIC with a comprehensive supervisory approach designed to detect and address the ILC's exposure to all risks arising from its affiliations in the holding company, such as reputation risk from an affiliate that has no relationship with the ILC. These limitations are most significant with respect to existing ILC holding companies that are not subject to conditions or written agreements made in connection with the ILC's application for insurance and whose ILCs are not currently financially troubled or exposed to risks from relationships with their affiliates.

Table 2 provides a summary of what FDIC officials told us about their authority over holding companies and affiliates of insured depository institutions and our analysis of the limitations of these authorities.

Table 2: The Extent of Selected FDIC Authorities

FDIC authority	Extent of authorities
Examine certain ILC affiliates.[a]	Only to determine whether the affiliate has a relationship with the ILC and, if so, to disclose the effect of the relationship on the ILC. The authority does not extend to determining how the affiliate's involvement in the holding company alone might threaten the safety and soundness of the ILC.
Impose conditions on or enter into agreement with an ILC holding company in connection with an application for deposit insurance.	Only in connection with an application for deposit insurance and cannot be used to unilaterally impose conditions on an ILC holding company after the application has been approved.
Terminate deposit insurance.	Only if certain notice and procedural requirements (including a hearing on the record before the FDIC Board of Directors) are followed after FDIC determines that • the institution, its directors or trustees have engaged in unsafe or unsound practices; • the institution is in an unsafe or unsound condition; or • the institution, its directors or trustees have violated an applicable legal requirement, condition of insurance, or written agreement between the institution and FDIC.
Obtain written agreements from the acquiring entity in connection with a proceeding to acquire an ILC.[b]	Could be used if grounds for disapproval exist with respect to the acquirer.
Take enforcement actions against ILC affiliates.[c]	Only if an affiliate is an IAP; and Only if the IAP engages in an unsafe or unsound practice in conducting the business of the ILC or has violated a legal requirement. If the IAP is functionally regulated, FDIC's enforcement grounds are further limited.

Source: GAO analysis of the supervisory authorities stated by FDIC officials.

[a]FDIC's ability to examine ILC affiliates is limited by the meaning of the term "relationship," which is unclear in situations where the ILC and the affiliate do not engage in transactions or share operations. In this respect, FDIC's authority is less extensive than consolidated supervision because (1) the examination authority of consolidated supervisors does not depend on the existence of a relationship and (2) without a relationship, FDIC generally needs the consent of the affiliate to conduct an examination of its operations.

[b]FDIC's ability to obtain written agreements from the acquiring entity in connection with a proceeding to acquire an ILC is limited because certain types of risks, such as reputation risk, could be unrelated to any of the grounds for disapproval of a CIBA notice. Moreover, this ability would not be related to concerns arising after the acquisition is made. Further, soma experts stated that it is unlikely that FDIC could require capital-related commitments from a financially strong, well managed commercial enterprise that seeks to acquire an ILC.

[c]In accordance with 12 U.S.C. §§1848a, 1831v(a), FDIC's authority to take action against a functionally regulated IAP is limited to where the action is necessary to prevent or redress an unsafe or unsound practice or breach of fiduciary duty that poses a material risk to the insured institution and the protection is not reasonably possible through action against the institution.

FDIC's Examination Authority Is Less Extensive Than a Consolidated Supervisor

FDIC officials stated that its examination authority is sufficient to address any significant risk to ILCs from holding companies and entities affiliated with the ILC through the holding company structure. For example, FDIC officials told us that it has established effective working relationships with ILC holding companies and has conducted periodic targeted examinations

of some ILC holding companies and material affiliates that have relationships with the ILC, which includes those affiliates that are providing services to or engaging in transactions with the ILC. FDIC officials also told us that these targeted reviews of holding companies and affiliates help to assess potential risks to the ILC and include the following:

- assessing the holding company's value-at-risk model used at its affiliate banks;[53]
- assessing the internal control and review processes developed at the holding company level and understanding how those processes are applied to the bank, including how the holding company's internal audit function is designed, scoped, and implemented with respect to the bank;
- reviewing information about the holding company's asset quality and its processes for analyzing risk such as: stress testing, review of commercial, industrial, and international loans and country risk ratings, and loan underwriting procedures developed at the holding company level and implemented at the bank; and
- assessing IT systems and controls related to the bank.

The scope of FDIC's general examination authority may be sufficient to identify and address many of the risks that holding company and affiliate entities may pose to the insured ILC. However, FDIC's general examination authority is less extensive than a consolidated supervisor's. Because FDIC can examine an ILC affiliate only to determine whether it has a relationship with the ILC and, if so, to disclose the effect of the relationship on the financial institution, FDIC cannot examine ILC affiliates in a holding company specifically to determine how their involvement in the holding company alone might threaten the safety and soundness of the ILC. When there is no relationship between the ILC and the affiliate, FDIC generally would need the consent of the affiliate to conduct an examination of its operations. According to its officials, FDIC could use its subpoena powers and other authorities under section 10(c) of the FDI Act to obtain

[53]Value-at-risk is an estimate of the potential losses that might occur in a portfolio due to changes in market rates, based on a specified period of time during which the rates change, and at a specified probability level. For example, a firm may generate a value at risk estimate for a 10-day period at 99 percent probability and arrive at a figure of $1 million. This means that 99 percent of the time it would expect its losses during a 10-day move of rates to be less than $1 million.

information, but the use of these powers appears to be limited to examinations or investigations relating to the insured depository institution.[54] In contrast, the examination authorities of the Board and OTS focus on the operations and financial condition of the holding company and its nonbank subsidiaries and specifically on financial and operations risks within the holding company system that can threaten the safety and soundness of a bank subsidiary.[55] To the extent that an affiliate's size, condition, or activities could expose the depository institution to some type of risk, such as reputation risk, where no direct relationship with the bank exists, the consolidated supervisory approach is more able to detect the exposure.[56] FDIC's authority does not permit it to examine an affiliate based solely on its size, condition, or activities. However, FDIC officials told us that it is unlikely that any serious risk could come from an affiliate that does not have a relationship with the insured institution. According to these officials, there have been no bank failures in the United States from reputation risk in the past 20 years. We agree that the most serious risk to an ILC would come from holding companies or affiliates that have a relationship with the ILC. However, the possibility that risks could come from affiliates with no relationship with the ILC cannot be overlooked. While no recent bank failures may have resulted from reputation risk, it continues to attract the attention of the FDIC and the Board.

Unlike the specific examination authority of the Board, the full extent of FDIC's examination authority over affiliates is unclear because there is no established definition of the term "relationship" in the context of FDIC's examination authority. Further, we are not aware of any judicial or legislative clarification of this term as it relates to FDIC examinations. According to FDIC officials, determining whether a relationship exists can be routine in cases where an insured institution and an affiliate engage in a transaction or share operations. However, in less obvious cases, the determination might involve circumstances that may be unique or unprecedented.

[54]See 12 U.S.C. § 1820(c).

[55]See, for example, the focus of bank holding company examinations as prescribed in the BHC Act. 12 U.S.C. § 1844(c)(2).

[56]See 12 U.S.C. 1844(c)(1)(C) (Board examinations, to fullest extent possible, are to be limited to examinations of holding company subsidiaries whose "size, condition, or activities" could adversely affect the affiliated bank's safety and soundness or where the nature and size of transactions between the affiliate and the bank could have that effect.)

However, both the Board and FDIC officials, as well as an expert we interviewed, generally agreed that the term connotes an arrangement in which there exists some level of interaction, interdependence or mutual reliance between the ILC and the affiliate, such as a contract, transaction, or the sharing of operations. Board officials expressed the view that the term has a limiting effect on affiliate examinations. FDIC officials told us that its use of this authority to examine ILC holding companies or entities affiliated with an insured institution in a holding company has never been challenged.

FDIC's Authority to Impose Conditions or Written Agreements Can Be Used in Certain Circumstances

FDIC officials also stated that it can use its authority to approve applications for deposit insurance as a means of requiring an ILC holding company to adopt commitments, operations and procedures that enhance the safety and soundness of the ILC. When reviewing an application for insurance, FDIC must consider the following seven statutory factors:[57]

- financial history and condition of the depository institution,
- adequacy of the institution's capital structure,
- future earnings prospects of the institution,
- general character and fitness of the institution's management,
- risk the institution presents to the deposit insurance fund,
- convenience and needs of the community to be served by the institution, and
- whether the institution's corporate powers are consistent with the FDI Act.

[57]See 12 U.S.C. §§ 1815(a)(4), 1816.

FDIC officials stated that because its primary mission is to protect the bank insurance fund, the FDIC's incidental powers and other authorities under the FDI Act authorize the FDIC to impose conditions on insurance where those conditions are warranted by the statutory factors.[58] Under its enforcement authority, FDIC can initiate proceedings against an IAP for violation of a condition imposed in writing by FDIC in connection with the granting of any application or request by the depository institution or any written agreement with the agency.[59] In March 2004, FDIC issued guidance that identified nonstandard conditions that might be imposed when approving applications for deposit insurance involving financial institutions to be owned by or significantly involved in transactions with commercial or financial companies. For example, among other things, FDIC can require that the majority of ILC management be independent of its holding company and affiliates, and that all arrangements to share management staff, personnel, or resources with the holding company or any affiliate be governed by written contracts giving the bank authority to govern its own affairs. FDIC officials told us that the approval of insurance could be conditioned upon the holding company's adhering to prescribed capital levels, adopting a capital maintenance plan for the ILC, and/or other measures such as submitting reports about affiliates to FDIC. For example, FDIC's policy is to favor capital commitments from holding companies of applicants for insurance.[60] However, FDIC officials were unable to provide examples where FDIC has imposed conditions on an application for insurance that required the holding company to provide specific reports of

[58]FDIC's incidental powers are set forth at 12 U.S.C. 1819(a)(Seventh).

[59]See 12 U.S.C. § 1818(b)(1).

[60]FDIC's Policy Statement on Applications for Deposit Insurance provides, in pertinent part, that: Where the proposed depository institution will be a subsidiary of an existing bank or thrift holding company, the FDIC will consider the financial and managerial resources of the parent organization in assessing the overall proposal and in evaluating the statutory factors prescribed in section 6 of the Act. . . . If the applicant (for deposit insurance) is being established as a wholly owned subsidiary of an eligible holding company, . . . the FDIC will consider the financial resources of the parent organization as a factor in assessing the adequacy of the proposed initial capital injection. In such cases, the FDIC may find favorably with respect to the adequacy of capital factor, when the initial capital injection is sufficient to provide for a Tier 1 leverage capital ratio of at least 8 percent at the end of the first year of operation, based on a realistic business plan, or the initial capital injection meets the $2 million minimum capital standard set forth in this Statement of Policy, or any minimum standards established by the chartering authority, whichever is greater. The holding company shall also provide a written commitment to maintain the proposed institution's Tier 1 leverage capital ratio at no less than 8 percent throughout the first 3 years of operation. See 67 Fed. Reg. 79276-79278 (Dec. 27, 2002).

operations, financial condition, and systems of monitoring risk at the holding company and affiliates. Although FDIC officials and examiners told us that no ILC holding company has refused to provide all of the reports and supporting documents that the examiners needed, our review found that FDIC examiners rely upon information about holding company and affiliate operations that is voluntarily provided by ILC holding companies during the course of an examination to assess the various types of risk from the holding company and affiliate operations, including various types of nonpublic information such as asset quality and loan underwriting. Further, FDIC officials told us that it has never imposed capital requirements on a holding company; rather, officials gave an example where a legally enforceable agreement to maintain a certain level of capital was obtained from the holding company. In addition to imposing conditions, FDIC could, according to its officials, enter into a written agreement with the holding company of an institution to establish a supervisory system similar to consolidated supervision. For example, the agreement could call for the holding company to correct conditions at the affiliate that presents risks to the ILC, provide reports about affiliates, or even a capital infusion into the ILC. According to FDIC officials, whether to impose capital and reporting requirements as conditions on insurance or achieve the same result through agreements with the holding company depends upon the circumstances of the application for insurance.

FDIC's authority does not permit it to impose conditions on an ILC holding company after the application has been approved. Should the ILC face risks from the holding company that are not adequately covered by insurance conditions or a written agreement with the holding company and do not arise from any relationship that the ILC has with an affiliate, FDIC would have to resort to some other means to achieve corrective action by the holding company, such as persuading the holding company to take action to avoid termination of the depository institution's insurance. FDIC officials also referred to procedures under the prompt corrective action (PCA) provisions of the FDI Act for undercapitalized institutions that can require action by a holding company, such as a guarantee to maintain the depository institution's capital at prescribed levels and divestiture of a significantly undercapitalized institution or any affiliate.[61] FDIC's PCA authority cannot be used unless the institution violates capital standards and is triggered only by a bank's capital deficiency. In contrast, under consolidated supervision, capital and reporting requirements are imposed

[61]See 12 U.S.C. § 1831o(e)(2)(C), (f)(I)(ii).

on holding companies of depository institutions to address the potential for risks arising from the holding company system. Moreover, consolidated supervision requirements can address risks that might not be discernible at a particular point in time, whereas FDIC can exercise its authorities only under certain circumstances, such as when an application for insurance is granted.

FDIC's Authority to Terminate Insurance Can Be Exercised in Certain Circumstances

FDIC officials stated that, even if conditions or agreements were not established in connection with the issuance of an ILC's insurance, the prospect of terminating an institution's insurance can serve to compel the holding company to take measures to enhance the safety and soundness of the ILC. Under the FDI Act, FDIC can initiate an insurance termination proceeding only if certain notice and procedural requirements are followed after a determination by the FDIC that (1) an institution, its directors, or trustees have engaged in or are engaging in an unsafe or unsound practice; (2) an institution is in an unsafe or unsound condition; or (3) the institution, its directors, or trustees have violated an applicable legal requirement, a condition imposed in connection with an application by the depository institution, or a written agreement between the institution and FDIC.[62] In addition, termination proceedings must be conducted in a hearing on the record, documented by written findings in support of FDIC's determination, and are subject to judicial review.[63] FDIC officials told us that if the grounds for termination exist, FDIC can provide the holding company of a troubled ILC with an opportunity to avoid termination by agreeing to measures that would eliminate the grounds for termination. These measures could include an agreement to infuse capital into the ILC or provide reports about the holding company and its affiliates. According to FDIC officials, the prospect of terminating insurance is usually sufficient to secure voluntary corrective action by a holding company to preclude the occurrence of an unsafe or unsound practice or condition or restore the institution to a safe and sound financial condition. FDIC officials stated that FDIC has notified insured institutions that it intended to terminate deposit insurance 184 times. Between 1989 and 2004, FDIC initiated formal proceedings to terminate deposit insurance in 115 of these cases because necessary corrections were not immediately achieved. In 94 of these 115

[62]The procedural requirements include notifying the appropriate federal or state banking supervisor of FDIC's determination for the purpose of securing a correction by the institution. 12 U.S.C. § 1818(a)(2)(A).

[63]See 12 U.S.C. § 1818(a)(3),(5).

instances, corrective actions were taken, and the deposit insurance was not terminated. For the remaining 21 of the 115 cases, FDIC terminated deposit insurance. FDIC officials told us that, after terminating deposit insurance, 17 of these institutions implemented appropriate corrective actions, and the insurance was subsequently reinstated.

As demonstrated by the number of institutions that took measures to enhance the safety and soundness of the insured depository institution, the threat of insurance termination has been an effective supervisory measure in many instances. However, FDIC's ability to use the possibility of insurance termination to compel the holding company to enhance the safety and soundness of the insured institution is limited. For example, because the statutory grounds for termination relate to the condition of the institution and practices of its directors or trustees, the prospect of termination would not be based solely on the condition or operations of an institution's affiliate. While conditions could exist in the holding company that might threaten the holding company and thereby indirectly threaten an ILC, these conditions would not serve as grounds for termination of insurance unless they caused the institution to be in an unsafe or unsound condition. Further, unlike the consolidated supervision approach, FDIC insurance termination authority does not give it power to require a holding company or any of its nonbank affiliates to change their operations or conditions in order to rehabilitate the ILC. The extent to which FDIC could enter into an agreement with a holding company would depend on whether the holding company has an incentive to retain the institution's insured status and/or the resources to take the action FDIC seeks.

In Certain Circumstances, FDIC May Enter Into Agreements in Connection with the Acquisition of an Insured Institution

FDIC officials also stated that if an entity sought to acquire an ILC, the regulatory process for such a transaction could afford FDIC an opportunity to seek an agreement from the prospective acquirer relating to matters such as capital maintenance, examinations, and reporting. Provisions of the Change In Bank Control Act (CIBA) set forth the reasons for which FDIC can disapprove the proposed acquisition of an insured ILC.[64] These include proposed acquisitions where (1) the financial condition of the acquiring company might jeopardize the financial stability of the depository institution; (2) the competence, experience, or integrity of the acquirer or proposed management personnel do not satisfy statutory standards; and where (3) FDIC determines that the acquisition would have an adverse

[64]FDIC's authority in connection with the acquisition of an insured institution is set forth at 12 U.S.C. §§ 1817(j).

effect on the deposit insurance fund. According to FDIC officials, it could use the prospects of disapproval on these or other grounds to force a potential acquirer to enter agreements that would address potential risks to an ILC arising from its presence in a holding company. FDIC officials described an instance where officials obtained an agreement from an acquirer to correct potential problems even before issuing disapproval of the CIBA notice to address the acquirer's request to avoid negative publicity.

FDIC's ability to reach an agreement in connection with an acquisition appears to be helpful in mitigating some of the risks that could arise at this time. However, FDIC's ability to obtain agreements in connection with a CIBA notice is limited when a prospective acquirer of an ILC does not trigger the statutory concerns described above. For example, some experts we talked with said it is unlikely that FDIC could use its CIBA authority to require capital-related commitments from a financially strong, well-managed commercial enterprise that seeks to acquire an ILC. Moreover, certain types of risk to a depository institution that can arise from its affiliations in a holding company, such as reputation risk arising from an affiliate of the acquirer, could be unrelated to any of the grounds for disapproval set forth in CIBA or could arise after the acquisition has been approved.

FDIC's Authority to Take Enforcement Actions Is Less Extensive Than a Consolidated Regulator

FDIC officials also stated that it can use its enforcement authority to compel certain institution affiliated parties of ILCs (a group that typically would include the ILC's holding company) to take measures relating to the safety and soundness of the ILC. However, FDIC has no enforcement authority over ILC affiliates that are not IAPs, and its ability to require an IAP to infuse capital into a troubled ILC appears to be limited. As discussed previously, FDIC has no authority to take action against an ILC affiliate whose activities weaken the holding company, and potentially the ILC, unless the affiliate is an IAP. If grounds for an enforcement action exist, FDIC can initiate an action against the insured institution or an IAP to obtain, among other things, a cease and desist order or civil money penalties.[65]

[65]Grounds for an enforcement action against an IAP include the occurrence or potential occurrence of an unsafe or unsound practice by the insured institution caused by the IAP's conducting the business of the institution or the violation of a law, regulation or other regulatory requirements by the institution or IAP. See 12 U.S.C. § 1818(b)(1).

FDIC officials told us that it could use its enforcement authority, under appropriate circumstances, to require an ILC holding company to take action necessary to protect or restore the safety and soundness of its affiliate insured institution, which action could include transferring capital into the institution or making a guarantee to do so. However, FDIC's ability to impose such requirements against a functionally regulated affiliate is limited.[66] Moreover, FDIC's authority to require an asset transfer in an administrative enforcement action may be limited. In a decision interpreting OTS' authority to require a holding company to comply with a written condition requiring the company to maintain the net worth of a savings bank affiliate, the District of Columbia Circuit Court (Court) held that OTS had no authority to require an asset transfer absent proof of the holding company's unjust enrichment or reckless disregard of its legal obligations.[67] In that decision, the Court observed that this same provision governs enforcement actions by other federal banking agencies, including FDIC. According to this decision, FDIC has no authority to require an ILC holding company to transfer assets to a troubled ILC solely because of the ILC's unsafe or unsound condition, unless the condition is the result of the holding company's use of the ILC for unjust enrichment or reckless disregard of a legal obligation to make the transfer. The Court's decisions in these cases also may limit the authority of the Board and OTS to require an asset transfer without proving unjust enrichment or reckless disregard of a legal requirement. In this regard, a bank holding company's reckless disregard of its obligation to maintain the financial safety and soundness of a subsidiary bank might satisfy the Court's requirements for a capital infusion.

[66]See 12 U.S.C. §§ 1831v, 1848a.

[67]Wachtel v.Office of Thrift Supervision, 982 F.2d 581 (D. Cir. 1993) (OTS lacks authority to require majority shareholder of a savings and loan to inject capital into the institution pursuant to a written agreement where OTS failed to prove unjust enrichment.); see also, Rapaport v. Office of Thrift Supervision, 59 F.3d 212 (1995).

FDIC Actions May Help Mitigate Potential Risks, but Supervision of ILC Holding Companies and Affiliates Has Only Been Tested on a Limited Basis in Relatively Good Economic Times

FDIC's bank-centric, supervisory approach has undergone various modifications to its examination, monitoring, and application processes, designed to help mitigate the potential risks that FDIC-examined institutions, including ILCs in a holding company structure, can be exposed to by their holding companies and affiliates. For example, FDIC revised the guidance for its risk-focused examinations to, among other things, provide additional factors that might be considered in assessing a holding company's potential impact on an insured depository institution affiliate. These changes may further enhance FDIC's ability to supervise the potential risks that holding companies and affiliates can pose to insured institutions in a holding company structure, including ILCs. In addition, FDIC's application process may also help to mitigate risks to ILCs with foreign holding companies and affiliates. While FDIC has provided some examples where its supervisory approach effectively protected the insured institution and mitigated losses to the bank insurance fund, questions remain about whether FDIC's supervisory approach and authority over BHC Act-exempt holding companies and affiliates addresses all risks to the ILC from these entities. Further, FDIC's supervision of large, rapidly growing ILCs and authority over BHC Act-exempt holding companies and nonbank affiliates has been refined during a period of time described as the "golden age of banking" and has not been tested during a time of significant economic stress or by a large, troubled ILC.

FDIC Examination and Monitoring Procedures May Help to Mitigate Risks to ILCs from Holding Companies and Affiliates

According to FDIC, its process for conducting safety and soundness examinations for ILCs is risk-focused and generally the same as for other banks under its oversight. These officials believed that an examiner's ability to exercise judgment to determine the depth of review in each functional area is crucial to the success of the risk-focused supervisory process. FDIC officials and examiners told us that, at every examination, FDIC reviews an institution's relationships with affiliated entities. According to FDIC's *Supervisory Insights*, in an examination of a depository institution with affiliates, including an ILC, FDIC examiners assess the bank's corporate structure, the bank's interactions with affiliates—which include a review of intercompany transactions and interdependencies—as well as the financial risks that may be inherent in the affiliate relationship. Once each on-site examination is initiated, the FDIC requests information from bank management to obtain items that serve as the starting point for reviewing the institution's relationships with affiliated entities. The requested information may include items such as the following:

- a list of officers and directors of affiliates, including organizational chart, if available;
- a list of affiliated organizations and their financial statements as of the financial statement date, or most recent date available;
- the most recent annual report, SEC 10-K report, and/or SEC 10-Q report (annual and quarterly financial filings to the SEC);
- a tax allocation agreement with the holding company;
- contracts for all business relationships with affiliates that provide services to the ILC; and
- the fee structure of transactions with the holding company and/or affiliates.

FDIC's examination manual notes that an institution's relationship with its affiliates is an important part of the analysis of the condition of the bank itself. The manual further states that, because of common ownership or management, transactions with affiliates may not be subject to the same sort of objective analysis by bank management that is used to analyze transactions between independent parties and that affiliates offer an opportunity to engage in types of business endeavors that are prohibited for the bank itself, yet may impact the condition of the bank. In March 2004, the FDIC updated the Related Organizations section of its examination manual to, among other things, expand the discussion of management's fiduciary responsibilities to ensure that an insured depository institution maintains a separate corporate existence from its affiliates; to provide additional factors that might be considered in assessing a holding company's potential impact on an insured depository institution affiliate, such as the independence of the bank's management from the holding company; and to emphasize examiners' authority under Section 10(b) and (c) of the FDI Act to examine affiliates of state nonmember banks, if deemed warranted.

Table 3 lists some of the examination procedures performed during a review of an institution with affiliates, including ILCs.

Table 3: Affiliate Related Examination Procedures

Procedure
Assessing the bank's corporate structure.
Reviewing intercompany transactions to determine how the bank interacts with the affiliates.
Reviewing the interdependencies of the bank and affiliates.
Evaluating any financial risks that may be inherent in the relationship.
Reviewing the current written business plan and evaluating any changes.
Reviewing any arrangements of shared management or employees.
Reviewing services provided to an affiliate to determine whether the same terms and conditions are in place as would be for nonaffiliated entities.
Reviewing the services purchased from an affiliate to determine whether the same terms and conditions are similar to those that would be applied to a nonaffiliated entity.
Assessing whether written agreements are in place for all service relationships.
Reviewing relevant documents to determine whether the bank has a contingency plan for all critical business functions performed by affiliated companies.

Source: FDIC.

Note: Adapted from *Supervisory Insights*, June 2004.

While the FDIC lacks specific authority to require that holding companies serve as a source of strength to affiliate financial institutions, FDIC officials told us that examination activities to assess the holding company's source of strength to the insured institution are performed at each examination. The examination manual also states that a sound, well-managed holding company can be a source of strength for unit banks and provide strong financial support because of its greater ability to attract and shift funds from excess capital areas to capital deficient areas. Moreover, the examination manual states that, when the financial condition of the holding company or its nonbanking affiliates is tenuous, pressures can be exerted on the affiliate bank by payment of excessive dividends, investing in high risk assets, purchase and/or trade of high quality assets for affiliates lower quality assets, purchase of unnecessary services, or payment of excessive management or other fees.

In its recent report on FDIC's approach to supervising limited-charter institutions, including ILCs, the FDIC-IG recommended that FDIC further revise its examination manual and policies to expand the discussion of the source of strength provided to an affiliate bank by the managerial and financial capabilities of the holding company and provide guidance and procedures to examiners for analyzing the holding company's source of strength. FDIC officials told us that, in December 2004, FDIC further

revised its manual to include more specific suggestions for analyzing whether a holding company, including a holding company of an ILC, may serve as a potential "source of strength." Currently, FDIC's manual provides specific guidance to examiners on: (1) measuring the ability of the holding company to cover its interest expense; (2) testing the holding company's cash availability to meet not only interest expenses, but also operating expenses, taxes, shareholders dividends, and debt maturities; and (3) assessing the risk to a bank through the use of dual-employee arrangements. FDIC officials told us that if the management or financial capacity of the holding company provides a significant source of strength to the ILC, this finding would typically be incorporated into the summary examination report. The FDIC-IG's report also stated that establishing uniform and complete policies and procedures for assessing a bank's corporate structure or relationships with affiliated entities, including the holding company, should help ensure that examiners adequately identify risks that may be inherent in the ILC-holding company relationship. The FDIC-IG concluded that FDIC could further improve its examination policies and procedures by (1) including specific procedures for examiners to follow in assessing dual-manager and dual-employee arrangements; (2) clarifying procedures with respect to reviewing business plans, operating budgets, or strategic planning documents to ensure that procedures are consistently applied; and (3) requiring examiners to calculate and provide financial ratios in the summary examination report, especially for ILCs. The report further states that, in the absence of Board holding company reports, these ratios could provide examiners with important insights about the impact that affiliates are having on the ILC.

Other aspects of FDIC's examination approach also help mitigate the risk that holding companies and affiliates may pose to insured institutions, including ILCs. For example, some ILCs are included in FDIC's Large State Nonmember Bank Onsite Supervision or "Large Bank" and Dedicated Examiner programs and receive continuous supervision. The Large Bank program provides an on-site presence at depository institutions through visitations and targeted reviews throughout the year as opposed to the traditional annual point-in-time examination. State nonmember banks with total assets of $10 billion or more are eligible. Institutions that do not meet the asset threshold can qualify for the Large Bank program based upon their size, complexity, and risk profile. Some of the major areas covered in the targeted reviews can include: capital markets activities, lending, risk management, operations, internal controls and audit, management supervision, capital, earnings, and liquidity. Three ILCs that represent nearly 75% of total ILC assets are currently part of the Large Bank program.

In addition, according to the FDIC-IG report, the FDIC established the Dedicated Examiner program in 2002 to appoint eight dedicated examiners to work closely with the primary federal supervisors of the eight largest insured depository institutions in the United States. Currently there are three holding companies that are monitored as part of the Dedicated Examiner program and, together, they own a total of four ILCs. These dedicated examiners work with examination staff from the Board, OTS, and OCC to obtain real-time access to information about the risk and trends in these organizations. According to FDIC officials, currently dedicated examiners for two of the three holding companies had not been assigned.

Examiners also use Call Report[68] data to monitor the condition of financial institutions and assist in prioritizing on-site safety and soundness examination efforts. In addition, according to FDIC officials and examiners we spoke with, examiners often obtain information, including holding company financial reports and monthly board of directors' meeting minutes, voluntarily provided by ILC management that can assist an examiner's ability to assess risks to the ILC. This documentation can include information regarding existing and planned transactions and contracts with its holding company and affiliates and can further assist in an examiner's ability to identify and assess potential risks to the ILC stemming from these relationships.

FDIC also works with state banking supervisors to examine ILCs, including assessing the risks that ILC holding companies and affiliates may pose to the insured institution. In May 2004, FDIC jointly developed recommended practices for state and federal supervisors to communicate and coordinate the planning and execution of supervisory activities.[69] Recommendations included: involving both the state and federal banking supervisors in meetings with bank management and directors; sharing reports produced through off-site monitoring or targeted supervisory activities; discussing and preparing supervisory plans at least once during the examination cycle,

[68]All commercial banks insured by the FDIC and all FDIC-supervised savings banks are required to submit quarterly Call Reports. The Call Report contains a variety of financial information that shows a bank's condition and income and is used for multiple purposes including assessing the financial health and risk of the institution.

[69]FDIC jointly developed the recommended practices as documented by the *State Federal Working Group Supervisory Agreement* together with the Board and the Conference of State Banking Supervisors.

or more frequently, as appropriate; and jointly discussing, coordinating, and executing all corrective action plans such as memoranda of understanding and cease and desist orders.

In addition, FDIC established a goal, as part of its 2004 Performance Plan, to develop an on-site examination program for nonbank holding companies. The program would establish procedures for examination of a nonbank or commercial holding company that owns an insured institution, beyond what is currently done to determine the holding company's potential effect on the insured institution. According to FDIC officials, a preliminary draft outline of the examination program had been provided to FDIC's legal and management divisions for comment in September 2004. FDIC officials also told us that proposals for the program are still being drafted. At this time, it is too early to determine how this program will enhance FDIC's ability to protect an insured depository institution from the potential risks that holding company and affiliate entities may pose.

FDIC's Application Process May Help to Mitigate Risks to ILCs from Foreign Holding Companies and Affiliates

As previously discussed, FDIC's authority to impose conditions on a holding company is limited to the circumstances previously discussed. However, its application process may help mitigate potential risks to ILCs from foreign holding companies. For example, deposit insurance applications from foreign owners are subject to the same approval and review processes as all other applications. While foreign banking organizations chartered in the European Union are already subject to consolidated supervision, FDIC officials told us that not all foreign-owned ILC holding companies are designated as foreign banking organizations (as defined by the Board) and, therefore, are not subject to consolidated supervision in their home country. According to FDIC, currently, only one of the five foreign-owned ILCs is owned by a foreign banking organization that is subject to comprehensive consolidated supervision in its home country. We reviewed an order approving an application for insurance from a foreign holding company of an ILC in which FDIC indicated that the proposed ownership structure presented some concerns because it had potential to present supervisory concerns similar to those posed by chain

banking organizations[70] and because part of the "chain" was located in another country and not subject to U.S. supervision. According to FDIC, chain banks present opportunities to shift low-quality assets and other funds between banks to avoid being detected by supervisors and auditors. FDIC's concerns were mitigated, in part, because of its ability to review publicly available information about the publicly traded holding company and the foreign bank affiliates' location in countries that appeared to have adequate supervisory regimes.

In addition, FDIC may impose conditions in foreign applications for deposit insurance when it is deemed necessary to insulate the ILC. For example, we reviewed an order approving an application for deposit insurance from a foreign holding company of an ILC in which FDIC imposed several conditions, including the following:

- requiring the holding company to establish a designated agent in the United States, prior to receiving deposit insurance;
- entering into a written agreement with FDIC whereby the holding company agrees to be subject to United States Court jurisdiction on domestic banking issues;
- prohibiting the bank from engaging in any transactions with non-U.S. affiliates without the prior written approval of the regional Director of the FDIC; and
- requiring the holding company to obtain and maintain current financial information on any non-U.S. financial affiliate prior and subsequent to entering into any transactions with the non-U.S. financial affiliate and making the information available for examiner review at the holding company's main office in the United States.

[70]According to FDIC, a chain banking organization is a group of two or more banks or savings and loan associations and/or their holding companies that are controlled directly or indirectly by an individual or company acting alone or through or in concert with any other individual or company. The linkage of several banks or holding companies into a chain creates a concentration of banking resources that can be susceptible to common risks including poor loan participation practices, common deficiencies in lending and/or investment policies, domineering or absentee ownership, insider abuses, or other self-serving practices. Further, FDIC has noted that chain banking organizations do not have to report financial information on a consolidated basis, thereby making offsite monitoring difficult.

State Supervisors Contribute to ILC Supervision, but Resources Vary

The state chartering authorities also play a role in supervising ILCs and their holding companies and affiliates. The states of California, Nevada, and Utah collectively supervise 49 of the 57 active, FDIC-insured ILCs. Like FDIC, they examine transactions and agreements that the ILCs may have with their holding companies and affiliates for compliance with sections 23A and 23B of the Federal Reserve Act. In addition, according to these state banking supervisors, they have authority to conduct examinations of holding companies and affiliates, although the scope of these authorities varies.[71] Utah officials also maintain that the Commissioner of Financial Institutions can, under general supervisory authority over financial institution holding companies, impose capital requirements on the holding company in order to protect the insured institution.[72] We also found that FDIC has written, formal information sharing agreements with all three states and has an agreement to accept examination reports prepared by California on alternate examination years and to conduct examinations jointly with Nevada and Utah.

Table 4 compares the examination resources and organizational structure of the state banking supervisory offices in all three states. As shown in the table, more than half of the institutions supervised by the state of Utah are ILCs while this percentage is significantly less in California and Nevada.

[71]Under Nevada Law, the Commissioner of Financial Institutions has authority to examine ILC affiliates for limited purposes. Nev. Rev. Stat. § 677.440 (2004). The laws of Utah and California provide for full examinations of ILC affiliates. Utah Code Ann. §§ 7-1-314, 7-1-510 (2004); Cal. Fin. Code § 3704 (2004).

[72]See Utah Code Ann. § 7-1-510.

Table 4: Comparison of Examination Resources and Organizational Structure of State Banking Supervisory Office

(Dollars in billions)

State banking supervisory office	Total number of insured institutions supervised	Number of ILCs supervised	Total ILC assets	Number of examination staff	Organizational structure
California Department of Financial Institutions	190	15	$13.7	120	Reports directly to the state Business, Transportation and Housing Agency
Nevada Division of Financial Institutions	29	5	$10.2	12	Reports directly to the state Department of Business and Industry
Utah Department of Financial Institutions	56	29	$115.0	33	Reports directly to the Governor of Utah

Sources: GAO and FDIC data.

Note: All data reported are as of December 31, 2004.

Table 4 also demonstrates that the supervisory resources available in each state and the organizational structure of each banking supervisory office vary. Further, the number of examination staff per regulated entity is similar for California and Utah while Nevada has fewer examiners per institution supervised. Additionally, Utah has supervisory oversight over almost half of the active ILCs, 29 out of the 57, and employs 33 examiners that are responsible for examining 56 state-supervised banking institutions, including ILCs. The Utah DFI reports directly to the state Governor. The Utah DFI recently provided ILCs in its jurisdiction the opportunity to voluntarily submit to continuous supervision by FDIC and Utah state supervisors, as part of FDIC's Large Bank program.[73] As a result, according to Utah officials, 4 ILCs have volunteered to participate.[74] California has supervisory oversight over 190 state-supervised banking institutions, including 15 ILCs and employs 120 examiners. The California Department

[73]FDIC's Large Bank program provides an onsite presence at depository institutions through visitations and targeted reviews throughout the year as opposed to the traditional annual point-in-time examination. FDIC Regional Directors or their designees are to determine which institutions qualify for the program, however FDIC guidance indicates that all state nonmember banks with total assets of $10 billion or more should be considered.

[74]Four Utah ILCs are eligible to participate in the Large Bank program. As of the date of this report, FDIC has approved three of these ILCs and the fourth is awaiting approval to participate.

of Financial Institutions reports directly to the state Business, Transportation and Housing Agency. Nevada has supervisory oversight over 29 state-supervised banking institutions, including 5 ILCs, and currently employs 12 examiners. As of the time of our review, the Nevada Division of Financial Institutions (Nevada DFI) was not accredited, largely due to limited staff resources. As a result, the Nevada DFI is unable to examine insured depository institutions without partnership with FDIC or other federal supervisors.[75] The Nevada DFI reports directly to the state Department of Business and Industry.

Questions Exist Regarding Whether the Bank-Centric Approach Addresses All Risks to the ILC

Officials from the FDIC and the Board disagree over whether the bank-centric approach to supervision, without the added components of the consolidated supervisory approach, effectively identifies all of the potential risks that holding companies and ILC may pose to the ILC. FDIC officials told us that its current supervisory approach focuses not only on the insured institution but also on the risks that holding companies and affiliates could pose to an insured institution in a holding company structure. FDIC notes in *Supervisory Insights* that its experience with ILCs reinforces the agency's position that effective bank-level supervision is essential in safeguarding institutions from risk posed by holding companies. However, officials from the Board told us that the bank-centric approach alone was not sufficient to protect banks from all the risks that holding company and affiliate entities could pose. These officials stated that consolidated supervision of holding companies is essential to ensuring the safety and soundness of institutions, like ILCs, that exist in a holding company structure.

According to FDIC officials, consolidated supervision of the holding company is not a superior method for protecting the insured entity; rather, these officials stated that the primary source of strength for the holding

[75] In June 1995, the Federal Financial Institutions Examination Council (FFIEC) issued guidelines for federal supervisors to use to determine whether to rely upon state examinations. The guidelines stipulate that the federal banking agencies will "accept and rely on State reports of examination in all cases in which it is determined that State examinations enable the Federal banking agencies to effectively carry out their supervisory responsibilities." According to FFIEC and FDIC criteria, the FDIC should consider the adequacy of state budgeting and examiner staffing in determining reliance placed on state examinations. In addition to FFIEC criteria, FDIC uses a number of other factors, including the state bank supervisor's accreditation through the Conference of State Bank Supervisors (CSBS). CSBS is the professional association of state banking departments responsible for chartering, regulating, and supervising the nation's state chartered banks.

company is usually the insured institution. FDIC officials told us that its bank-centric approach is not limited in its focus and that examiners have access to whatever they need in order to assess potential risks to the insured institution. As noted previously, FDIC officials provided examples of where examiners conducted targeted reviews of selected operations of the holding company and material affiliates of several ILCs. In addition, officials stated that the bank-centric approach has effectively mitigated losses to the bank insurance fund stemming from troubled banks. For example, FDIC officials told us about its efforts to protect Conseco Bank—an insured ILC whose assets, at one point, totaled $3 billion—from operations and reputation risk from its parent company that eventually filed for bankruptcy after experiencing financial difficulty from acquiring a business with a poor loan portfolio. In this instance, FDIC, the state supervisor, and the bank developed a mutually agreed upon plan to protect Conseco Bank by implementing policies that placed more control in the hands of bank management. For example, the plan prohibited the bank from paying dividends to any affiliate, including the parent, and required Conseco Bank to sell its problem loans to the parent. Also, since loan servicing for Conseco Bank was provided by an affiliate of the parent, the agreement required the parent to sell the loan servicing affiliate to Conseco Bank to improve the independence and continuity of the bank's operations. The FDIC and state supervisor closely monitored Conseco Bank throughout the parent's bankruptcy proceedings. Eventually, Conseco Bank was marketed and ultimately sold for full value with no loss to the Fund.

FDIC told us of three other examples where its bank-centric approach effectively managed the risks being posed by holding companies and their subsidiaries to ILCs that were troubled. In one example, the FDIC established a written agreement with the ILC prohibiting it from paying dividends to its holding company or its affiliates without FDIC approval or engaging in transactions covered under the limitations set forth in sections 23A and 23B of the Federal Reserve Act. In two other examples, FDIC enforced corrective actions that were applicable to the ILC, as well as the holding company and the ILC's affiliates. Specifically, in one instance, a cease and desist order to end unsafe and unsound banking practices and enforce sections 23A and 23B transaction limits were applicable to the ILC, as well as the holding company and its subsidiary organizations. In the other example, FDIC entered into a written agreement with the ILC because of declines in its asset quality, as well as a capital and liquidity assurance agreement with the holding company. As a result, the holding company provided the ILC with a capital infusion and purchased its low

quality assets. None of these troubled ILCs failed and no losses were incurred by the Fund.

According to the FDIC-IG, two recent ILC failures, Pacific Thrift and Loan in 1999 and Southern Pacific Bank in 2003, resulted in material losses to the Fund totaling more than $105 million.[76] As a result of the failures, the FDIC-IG made several recommendations to revise FDIC's supervisory approach, which FDIC implemented. According to FDIC officials, other conditions in the banking industry that occurred at the same time of the ILC failures were also contributing factors to the changes that FDIC made to its supervisory approach. Specifically, since 1999, FDIC has, among other things, modified its risk focused examination procedures; issued guidance to examiners on topics such as risk from examining subprime lending programs and real estate lending standards; and hosted a symposium to discuss the lessons learned from these failures. According to FDIC, both failures were generally the result of ineffective risk management and poor credit quality. Table 5 provides a summary of the causes of the ILC failures and a description of the various corrective actions that FDIC officials told us were taken in response to the failures and other conditions in the banking industry that occurred during the same time period.

[76]From 1985 through year-end 2003, a total of 21 ILCs failed, including those discussed above. The other 19 failures did not result in material losses to the bank insurance fund; therefore, the FDIC-IG did not conduct a review. A material loss review by the Inspector General of the principal federal regulator of a failed institution is required when the estimated loss to the bank or savings association insurance funds exceeds the greater of $25 million or 2 percent of the institution's total assets at the time the FDIC was appointed receiver. These 19 ILCs were operated as finance companies, and their average total assets were $23 million. According to FDIC, most of the failures were small California ILCs that failed during the banking crisis of the late 1980s and early 1990s.

Table 5: Causes of Material ILC Failures and FDIC's Response to Failures and Other Industry Conditions

Name of ILC (year of failure) assets at closing	Cause of failure	Amount of loss to the fund	FDIC's response
Pacific Thrift & Loan; Woodland Hills, Calif. (1999) **Total assets: $117.6 million at closing**	Poor corporate governance. Poor risk management. Lack of risk diversification. Annual financial statement audit did not identify the actual financial condition of the bank. Inappropriate accounting for estimated future revenue from high risk assets. Auditors did not provide a written report of internal control weaknesses to the bank audit committee and examiners. Auditors did not provide examiners access to workpapers and supporting documentation.	$42 million (as of 01/01/02)	Modified risk focused examination procedures. Issued internal guidance on: • subprime lending programs, and • real estate lending standards. Modified guidance for examining high-risk residual assets (e.g., Modifications to Capital Markets Examination handbook, specifically mortgage derivative securities, asset-backed securities, structured notes, and securitization).[a] Issued a proposed rule to revise risk-based capital requirements (e.g., Financial Institution Letter, *Capital Treatment of Residual Interest in Asset Securitizations*, issued 9/2000). Hosted a symposium for FDIC regional management on "Lessons Learned" from bank failures. Required that contracts with third parties providing audit services include a provision to provide examiners access to audit workpapers and supporting materials.
Southern Pacific Bank; Torrance, Calif. (2003) **Total assets: $1.1 billion at closing**	Poor corporate governance. Poor risk management. Lack of risk diversification. Annual financial statement audit did not identify the actual financial condition of the bank. Auditors did not provide a written report of internal control weaknesses to the bank audit committee and examiners.	$63.4 million (as of 12/31/04)	

Sources: GAO, FDIC, and FDIC-IG.

Note: This table is based on information from FDIC-IG's material loss reviews and interviews with and documentation from FDIC.

[a]Mortgage derivative and asset backed securities refer to securities created from securitized assets. Structured notes are debt securities whose principal and interest payments vary according to specific formulas or as a result of changes in exchange rates or equity and commodity prices, they may also contain derivatives or financial contracts based on, or derived from, an underlying market, such as stocks, bonds, or currencies.

Board officials told us that they had a different view of the FDIC-IG reports concerning the two ILC failures that resulted in material losses to the bank insurance fund. According to Board officials, the lack of consolidated supervision at the holding company level contributed to the problems that impacted the ILCs. For example, these officials stated that the failure of Pacific Thrift and Loan was, in part, due to problems at the holding company level that were affecting the bank. To support their view, Board officials highlighted that the FDIC-IG reported that the holding company accumulated more debt than could be supported by the dividends it received from the ILC, thereby allowing the ILC to generate loans without reliable and stable funding sources. Officials from the Board stated that, as a result, the holding company implemented an aggressive high-risk strategy to boost profitability and pay these debt instruments, which resulted in significant losses and the holding company's inability to raise enough capital to help the ILC. Board officials told us that, because the holding company of Pacific Thrift and Loan was exempt from the BHC Act, no federal supervisor had examined the holding company, and the regulatory capital requirements that would have limited the borrowings of the holding company did not apply. While the lack of federal supervision of the holding company was not explicitly stated as a cause of failure in the FDIC-IG's material loss review of Pacific Thrift and Loan, the FDIC-IG's review discusses this matter in detail. Board officials told us that the ability to see a broader picture of, and take enforcement action against, the holding company would have enabled FDIC to identify and correct problems at the holding company before the ILC failed. Further, the FDIC-IG's material loss review recommended that FDIC remind its examiners of the agency's authority to examine holding companies and affiliates. Subsequently, FDIC examiners performed two on-site visitations of the holding company of Southern Pacific Bank, before it failed in 2003, to determine the overall condition of the holding company and its ability to support the ILC.

Board officials told us that the bank-centric approach alone is not sufficient to assess all the risks that a holding company and affiliates can pose to an insured financial institution. Board officials also stated that consolidated supervision has a long, successful history of assessing the potential risks that holding company and affiliate organizations may pose to insured depository institutions. According to Board officials, in order to understand the risks within a holding company structure and how they are dispersed, bank supervisors must assess risks across business lines, by legal entity, and on a consolidated basis. Board officials note that consolidated supervision provides its examiners with both the ability to understand the financial strength and risks of the overall holding company—especially

operations and reputation risk—and the authority to address significant management, operations, capital, and other deficiencies throughout the organization before these deficiencies pose a danger to affiliate insured banks and the bank insurance fund.

Further, Board officials stated that focusing supervisory efforts on transactions covered by sections 23A and 23B will not cover the full range of risks that insured institutions are exposed to from holding companies and their subsidiaries. Board officials told us that sections 23A and 23B violations most often occur in smaller organizations, and the risks posed by large organizations are more often related to other issues such as internal controls and computer systems problems. These officials stated that FDIC would likely not be able to detect these problems in a large holding company unless it was able to supervise the entire organization on a consolidated basis. In addition, Board officials stated that operations and reputation risk cannot be effectively assessed by focusing on sections 23A and 23B limitations. Board officials told us, for example, that these risks could come from a lending affiliate in the holding company that has loans outstanding to the same borrower as the ILC, but the affiliate does not do any business with the ILC. If this lending affiliate engaged in improper lending practices, it could impact the reputation of the holding company and ultimately affect the ILC. Further, the lending limits of both the ILC and the affiliate could be within an acceptable range, based upon a review of each individual organization's financial statements. However, based upon a consolidated view of the holding company's financial statement, the amount of loans from the ILC and the affiliate to the borrower could expose the consolidated entity to risk from a concentration of credit, which could ultimately impact the ILC. According to Board officials, it is unclear whether the FDIC's bank-centric approach would be able to detect either condition given that the ILC does not do business or otherwise have a relationship with the lending affiliate.

In our 1995 testimony to the House Committee on Banking and Financial Services, we presented our views on the need for consolidated supervision of bank holding companies. Based upon our work evaluating the effectiveness of bank supervision and examination during the 1980s and 1990s, we discussed specific safeguards that are necessary to protect

against undue risks.[77] These safeguards included a comprehensive regulation of financial services holding companies on both a functional and consolidated basis. We stated that an umbrella supervisory authority needs to exist to adequately assess how risks to insured banks may be affected by risks in the other components of the holding company structure. In addition, we also stated that capital standards for both insured banks and financial services holding companies that adequately reflect all major risks, including market and operations risk, were a necessary safeguard. Because our past work on failed banks and thrifts found that capital can erode quickly in times of stress, we stated that supervisors should also be required to conduct periodic assessments of risk management systems for all the major components of the holding company, as well as for the holding company itself.

Our belief in the importance of consolidated supervision and consolidated capital standards is partly based on the fact that most bank holding companies are managed on a consolidated basis, with the risks and returns of various components being used to offset and enhance one another. In addition, past experience has shown that, regardless of whether regulatory safeguards—such as sections 23A and 23B limitations—are set properly, even periodic examinations cannot ensure that regulatory safeguards can be maintained in times of stress. However, the consolidated supervisory approach is flexible enough to account for and recognize the contagion or systemic risks inherent in a holding company structure. Further, it appears that, in some instances, FDIC also embraces this concept. For example, in an order approving a foreign organization's application for deposit insurance in January 2004, FDIC expressed concerns over the difficulty of monitoring foreign affiliates that were not subject to U.S. supervision.[78] The order states that FDIC has embraced the concept of effective, comprehensive, consolidated supervision.

[77] For the 1995 testimony, see *Financial Regulation: Modernization of the Financial Services Regulatory System* (GAO/T-GGD-95-121, Mar. 15, 1995). In addition to this testimony, other GAO products present similar views on consolidated supervision. See, for example, *Separation of Banking and Commerce* (GAO/OCE/GGD-97-61R); the *U.S. Bank Oversight: Fundamental Principles for Modernizing Structure* (GAO/T-GGD-96-117, May 2, 1996); *Bank Oversight Structure: U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure* (GAO/GGD-97-23, Nov. 20, 1996); *Bank Powers: Issues Related to Repeal of the Glass-Steagall Act* (GAO/GGD-88-37, Jan. 22, 1988).

[78] *In Re:* Toyota Financial Savings Bank Henderson, Nevada, Application for Federal Deposit Insurance, Federal Deposit Insurance Corporation, January 2004.

FDIC's Supervisory Model and Authority Over BHC Act-Exempt Holding Companies and Nonbank Affiliates Has Been Tested on a Limited Basis in Relatively Good Economic Times

Although there have been material losses to the bank insurance fund resulting from two ILC failures in the past 6 years, the remaining 19 ILC failures occurred during the banking crisis in the late 1980s and early 1990s. Most of these ILCs were small California Thrift and Savings and Loan companies that, according to FDIC, had above-average risk profiles. FDIC's analysis of bank failures during this time period indicates that California experienced deteriorating economic conditions and a severe decline in the real estate industry, which contributed to the failure of 15 ILCs in that state. As previously discussed, FDIC has since implemented changes to its supervisory approach and has told us about some recent examples where, according to FDIC, its supervisory approach—including its influence and authority as the provider of deposit insurance—has effectively protected the insured institution and prevented losses to the Fund. However, all of the ILCs that failed since the late 1980s, as well as those ILCs that became troubled and FDIC took corrective action, were relatively small in size compared with some of the large ILCs that currently dominate the industry. FDIC has not provided any examples where its supervisory approach was used to mitigate potential losses from troubled ILCs that would qualify for supervision under its Large Bank program.

As previously discussed, because FDIC has established positive working relationships with ILC holding companies, examiners are able to obtain information about holding company and affiliate operations, supplied by ILC holding companies on a voluntary basis, from large, complex ILCs. According to examiners we spoke with, this information enhances FDIC's ability to monitor the potential risks posed by holding companies and affiliates to the insured ILC and, in some instances, this information is not publicly available. Further, according to FDIC, its requests for information about holding company and affiliate organizations have not been challenged in court. Therefore, it is not clear whether FDIC would be able to successfully obtain needed information about holding company and affiliate organizations in the absence of consent by the holding company or affiliate.

FDIC's supervisory model and authority over BHC Act-exempt ILC holding companies and affiliates has emerged during a time when banking has not confronted an adverse external environment. FDIC Chairman Donald Powell has described the past decade as a "golden age" of banking. The past 10 years can be characterized by stable economic growth, which has contributed to strong industry profitability and capital positions. During the past 7 years, only 35 financial institutions protected by the Fund have failed, and FDIC has reported that insured institutions' earnings for 2004

set a new record for the fourth consecutive year and that the industry's equity capital ratio is at its highest level since 1938.[79] In contrast, 1,373 financial institutions protected by the Fund failed between 1985 and 1992 due to, among other things, poor management and poor lending practices. How FDIC's supervisory approach would fare for large, troubled ILCs during an adverse external environment is not clear.

ILCs May Offer Commercial Holding Companies a Greater Ability to Mix Banking and Commerce Than Other Insured Depository Institution, but Views on Competitive Implications Are Mixed

Because most ILC holding companies and their subsidiaries are exempt from business activity limitations that generally apply to the holding companies and affiliates of other FDIC-insured depository institutions, ILCs may provide a greater means for mixing banking and commerce than ownership or affiliation with other insured depository institutions. During our review, we found other more limited instances where the mixing of banking and commerce previously existed or currently exists, such as unitary thrift holding companies, certain "nonbank banks," and certain activities permitted under GLBA, such as merchant banking and grandfathered, limited nonfinancial activities by securities and insurance affiliates of financial holding companies. However, federal law significantly limits the operations and product mixes of these entities and activities as compared with ILCs. Additionally, with the exception of a limited credit-card-only bank charter, ownership or affiliation with an ILC is today the only option available to nonfinancial, commercial firms wanting to enter the insured banking business. The policy generally separating banking and commerce is based primarily on potential risks that integrating these functions may pose, such as the potential expansion of the federal safety net provided for banks to their commercial entities, potential increased conflicts of interest, and the potential increase in economic power exercised by large conglomerate enterprises. While some industry participants state that mixing banking and commerce may offer benefits from operational efficiencies, empirical evidence documenting these benefits is mixed.

[79]Equity capital or financing is money raised by a business in exchange for a share of ownership in the company. Financing through equity capital allows a business to obtain funds without incurring debt or without having to repay a specific amount of money at a particular time. The equity capital ratio is calculated by dividing total equity capital by total assets.

ILC Charter May Offer Commercial Holding Companies More Opportunity to Mix Banking and Commerce Than Other Insured Depository Institution Charters

ILC holding companies and their affiliates may be able to mix banking and commerce more than other insured depository institutions because the holding companies and affiliates of ILCs are not subject to business activity limitations that generally apply to insured depository institution holding companies. Except for a limited category of firms, such as grandfathered unitary thrift holding companies and companies that own limited purpose credit card banks (CEBA credit card banks), entities that own or control insured depository institutions generally may engage, directly or through subsidiaries, only in activities that are financial in nature.[80] Because of a provision in the BHC Act excluding certain ILCs from the act's coverage, an entity can own or control a qualifying ILC without facing the activities restrictions imposed on bank holding companies and nonexempt thrift holding companies. As a result, the holding companies and affiliates of some ILCs and other subsidiaries are allowed to engage in nonfinancial, commercial activities. Today, nonfinancial, commercial firms in the automobile, retail, and energy industries, among others, own ILCs. According to the FDIC officials, as of December 31, 2004, 9 ILCs with total assets of about $3 billion directly support their parent's commercial activities. However, these figures may understate the total number of ILCs that mix banking and commerce because 5 other ILCs are owned by commercial firms that were not necessarily financial in nature. Because these corporations, on a consolidated basis, include manufacturing and other commercial lines of business with the financial operations of their ILC, we determined that these entities also mixed banking and commerce. Thus, we found that, as of December 31, 2004, approximately 14 of the 57 active ILCs were owned or affiliated with commercial entities, representing about $9.0 billion, (about 6.4 percent) and $4.6 billion (about 6.2 percent) of total ILC industry assets and estimated insured deposits, respectively.[81]

[80] See 12 U.S.C. §§ 1843, 1467a(c). As previously discussed, grandfathered unitary thrift holding companies are not subject to these activities restrictions. Limited purpose credit card banks also are exempt from the BHC Act. See 12 U.S.C. § 1841(c)(2)(F).

[81] When determining the current levels of mixed banking and commerce within the ILC industry, we considered only ILCs owned or affiliated with explicitly nonfinancial, commercial firms. Because some owners and operators of ILCs are engaged in business activities that are generally financial in nature, but still may not meet the statutory requirements of a qualified bank or financial holding company, officials from the Federal Reserve Board noted that they interpret the level of mixed banking and commerce among ILCs may be greater than 6.4 percent of industry assets and 6.2 percent of industry estimated insured deposits.

During our review, regulators and practitioners we spoke with highlighted other, more limited, historical exceptions to the policy generally separating banking and commerce, such as unitary thrift holding companies and "nonbank banks"—both of which at one time allowed for instances where insured banks could be owned by or affiliated with nonfinancial, commercial firms. Regulators also provided us with other current examples of limited mixed banking and commerce in the financial system, such as the merchant banking operations of financial holding companies and CEBA credit card banks, which offer limited opportunities to attract insured deposits and no commercial lending opportunities, but are permitted to be owned by or affiliated with commercial firms. However, because of the wide variety of products and services that ILCs offer and the continued availability of this charter type in certain states,[82] ILCs may offer commercial holding companies a greater opportunity to mix banking and commerce than these other exempted insured depository institutions and currently more limited situations of mixed banking and commerce. Additionally, with the exception of the more limited CEBA credit card only bank charter, ownership or affiliation with an ILC is today the only option available to nonfinancial, commercial firms wanting to enter the insured banking business.

Unitary thrift holding companies or unitary savings and loan holding companies are firms that own or control a single FDIC-insured thrift or savings and loan and typically own or control other subsidiaries. The Savings and Loan Holding Company Act of 1967 (HOLA) established the regulatory framework for unitary thrift holding companies. Unitary thrift holding companies were at one time permitted to own one thrift association and engage, without limitation, in other activities, including commercial activities, as long as the thrift complied with requirements intended to maintain its function as a thrift.[83] In 1999, as previously discussed, GLBA prohibited new unitary thrift holding companies from being chartered after May 4, 1999.[84] GLBA also "grandfathered" existing unitary thrift holding companies and limited the existing commercial

[82]In 2003, California and Colorado enacted laws restricting ownership or control of ILCs to financial firms. As a result, greater mixed banking and commerce for the holding company's affiliates of ILCs is not available to owners of California and Colorado ILCs.

[83]In 1967, Congress enacted the current version of the Savings and Loan Holding Company Act, Pub. L. No. 90-255, 82 Stat. 5 (1968). In that legislation, Congress permitted unitary thrift holding companies to engage in nonthrift business.

[84]Pub. L. No. 106-102 § 401 (1999).

powers of a unitary thrift holding company to the owners at that time. Thus, after this date, new owners of a unitary thrift would be unable to engage in commercial, nonfinancial activities. While many of the original commercial owners of unitary thrift holding companies have since sold their insured thrifts, several "grandfathered" commercially owned or affiliated unitary thrift holding companies remain active. As of December 31, 2004, there were 17 commercially owned or affiliated unitary thrift holding companies representing $38.7 billion in assets and $15.0 billion in estimated insured deposits.

Officials from the OTS highlighted several limitations of unitary thrift holding companies that made this charter more restrictive in its ability to mix banking and commerce than ILCs. These limitations for unitary thrift holding companies include the following:

- prohibitions on lending to commercial affiliates of the insured thrift;[85]
- restrictions on commercial lending to 20 percent of assets, provided any amount over 10 percent is in small business lending;[86] and
- restrictions under the qualified thrift lender test (QTL), including holding at least 65 percent of its assets in qualified thrift investments, which are primarily mortgage related assets.[87]

OTS officials told us that the restrictions on extending credit to commercial affiliates in the unitary thrift holding company structure prevents a unitary thrift holding company from using the insured thrift to fund nonbanking activities of the holding company. Unlike qualified thrifts, ILCs are not subject to restrictions on extending credit to commercial affiliates, limitations on the amount of commercial lending activity they can engage in, or restrictions on the mix of assets in their loan portfolios.

A similar, but even more limited, historical exception to the policy generally separating banking and commerce was, at one time, granted to "nonbank banks"—generally financial institutions that either accepted demand deposits or made commercial loans but did not engage in both

[85]See 12 U.S.C. § 1468(a).

[86]See 12 U.S.C. § 1464(c)(2)(A).

[87]See 12 U.S.C. § 1467a(m).

activities. Because the BHC Act defined a bank as a firm that did both of these activities, a company could own or control a "nonbank bank" and avoid federal supervision as a bank holding company. Similar to ILCs, the owners and affiliates of "nonbank banks" were able to mix banking and commerce prior to 1987 when CEBA was enacted. In effect, CEBA ended the ability to mix banking and commerce through the "nonbank bank" charter, because activity limitations on bank holding companies limit the holding companies' ability to own a bank and commercial affiliates. CEBA grandfathered the organizations that acquired a nonbank bank prior to March 5, 1987, provided that the organization did not undergo a change in control after that date and the organization and its nonbank bank abide by various restrictions contained in the BHC Act. Currently, only eight grandfathered nonbank banks remain in existence.

In addition to these historical exemptions, other more limited opportunities to mix banking and commerce currently exist, such as merchant banking and portfolio investing by the securities and insurance affiliates of financial holding companies and CEBA credit card only banks. Merchant banking refers to the practice where a financial institution makes a passive equity investment in a corporation with a view toward working with company management and operating partners to enhance the value of the equity investment over time. Merchant banking can result in ownership of significant portions of a firm's equity. GLBA relaxed long-standing restrictions on the merchant banking activities of banking organizations by permitting qualified financial holding companies to own and operate merchant banking entities. However, GLBA contains several provisions that are designed to distinguish merchant banking investments from the more general mixing of banking and commerce.[88] For example, merchant banking investments may only be held for a period of time to enable the resale of the investment, and the investing financial holding company may not routinely manage or operate the commercial firm except as necessary or required to obtain a reasonable return on the investment on resale.[89] Similarly, CEBA credit card banks, which are exempt from the BHC Act, offer limited opportunities to mix banking and commerce because they can

[88]In the GLBA, Congress authorized FHCs to engage in merchant banking activities through nondepository institution subsidiaries under specific conditions, thus allowing an FHC to acquire or control, directly or indirectly, any kind of ownership interest in any entity engaged in any kind of trade or business, subject to rules to be promulgated by the FRB and the Secretary of the Treasury. See H. Rep. No. 106-434 at 154.

[89]See 12 U.S.C. § 1843(k)(4)(H).

be owned by or affiliated with nonfinancial, commercial firms but, because of the nature of their charter, are limited scope banking entities. CEBA credit card banks are FDIC-insured institutions whose only business is credit cards. A CEBA credit card bank is not allowed to offer demand deposits or NOW accounts, can accept only "jumbo deposits" ($100,000 minimum), may have only one office that accepts deposits, and cannot make any commercial loans.[90]

Industry practitioners we spoke with also highlighted examples of commercial firms providing bank-like services through finance subsidiaries, such as the credit card operations of selected retailers or the financing subsidiaries of manufacturing firms—often referred to as captive finance subsidiaries because their business operations generally focus on providing credit to support the sale of a holding company or affiliate's products. For example, selected manufacturers of furniture, tractors, boats, and automobiles may offer credit through financing subsidiaries. However, banking regulators told us that captive financing subsidiaries are generally limited scope operations that must rely on the capital markets, their commercial holding companies, or banks for funding, and may not offer insured deposits. Banking regulators also stated that insured depository institutions generally can offer a broader range of banking services and can attract insured deposits as an attractive source of funding. Because the noninsured finance subsidiaries of commercial firms are not permitted to offer insured deposits, noninsured finance subsidiaries do not represent risk to the federal bank insurance fund.

Additionally, several developed countries allow greater mixing of banking and commerce than the United States. For example, in European countries there are generally no limits on a nonfinancial, commercial firm's ownership of a bank. However, the European Union has mandated consolidated supervision. Japan has allowed cross-ownership of financial services firms, including banks and commercial firms, permitting development of industrial groups or *keiretsu* that have dominated the Japanese economy. These groups generally included a major or "lead" bank that was owned by other members of the group, including commercial firms, and that provided banking services to the other members. The experience of these nations provides some empirical evidence of the effects of increased affiliation of banking and commercial businesses, particularly pointing to the importance of maintaining adequate credit

[90]See 12 U.S.C. § 1841(c)(2)(F).

underwriting standards for loans to affiliated commercial businesses. Problems in Japan's financial sector, notably including nonperforming loans, often to commercial affiliates of the banks, have contributed in part to the persistent stagnation of the Japanese economy beginning in the 1990s. However, important differences between the financial and regulatory systems of these nations and the United States, and limitations in research into the effects of these affiliations, limit many direct comparisons.

Mixing Banking and Commerce Presents Both Risks and Potential Benefits

The mixing of banking and commerce can potentially come about in many different forms. For example, banks may want to enter nonfinancial activities, and commercial firms may want to enter banking. A bank may also want to take an equity stake in a commercial firm, or a commercial firm may want to make an ownership investment in a bank. The forms of mixing banking and commerce differ depending on the firms' and banks' motivations. In the ILC industry, mixing banking and commerce has primarily been in the form of commercial, nonfinancial firms owning and operating insured banks.

The policy generally separating banking and commerce is based primarily on limiting the potential risks that may result to the financial system, the deposit insurance fund, and taxpayers. As discussed more fully below, we have previously reported that the potential risks that may result from greater mixing of banking and commerce[91] include the (1) expansion of the federal safety net provided for banks to their commercial entities, (2) increased conflicts of interest within a mixed banking and commercial conglomerate, and (3) increased economic power exercised by large conglomerate enterprises. However, generally the magnitudes of these risks are uncertain and may depend, in part, upon existing regulatory safeguards and how effectively banking regulators monitor and enforce these safeguards.

The federal government provides a safety net to the banking system that includes federal deposit insurance, access to the Federal Reserve's discount window, and final riskless settlement of payment system transactions. According to Federal Reserve officials, the federal safety net in effect provides a subsidy to commercial banks and other depository

[91]GAO, *Separation of Banking and Commerce*, GAO/OCE/GGD-97-16R (Washington, D.C.: Mar. 17, 1997).

institutions by allowing them to obtain low-cost funds because the system of federal deposit insurance shifts part of the risk of bank failure from bank owners and their affiliates to the federal bank insurance fund and, if necessary, to taxpayers. The system of federal deposit insurance can also create incentives for commercial firms affiliated with insured banks to shift risk from commercial entities that are not covered by federal deposit insurance to their FDIC-insured banking affiliates. As a result, mixing banking and commerce may increase the risk that the safety net, and any associated subsidy, may be transferred to commercial entities. The potential transfer of risks among insured banks and uninsured commercial affiliates could result in inappropriate risk-taking, misallocation of resources, and uneven competitive playing fields in other industries. As noted by regulators and practitioners we spoke with, these risks may be mitigated by regulatory safeguards between the bank and their commercial affiliates. For example, requirements for arms-length transactions and restrictions on the size of affiliate transactions under sections 23A and 23B of the Federal Reserve Act are a regulatory safeguard designed to protect an insured institution from adverse intercompany transactions. However, during times of stress, these safeguards may not work effectively—especially if managers are determined to evade them.

The mixing of banking and commerce could also add to the potential for increased conflicts of interest and raise the risk that insured institutions may engage in anticompetitive or unsound practices. For example, some have stated that, to foster the prospects of their commercial affiliates, banks may restrict credit to their affiliates' competitors, or tie the provision of credit to the sale of products by their commercial affiliates. Commercially affiliated banks may also extend credit to their commercial affiliates or affiliate partners, when they would not have done so otherwise. For example, when a bank extends credit to an affiliate, customers, or suppliers of an affiliate, the credit judgment could be influenced by that relationship. While current regulatory safeguards are designed to mitigate this possibility, advocates of continued separation highlight that the potential for more frequent misallocation of credit opportunities is greater in a merged banking and commercial environment. These advocates have stated that increased conflicts of interest could result in greater numbers of loans to commercial affiliates with favorable terms, relaxed underwriting standards, preferential lending to suppliers and customers of commercial affiliates, and ultimately increased risk exposure to the federal bank insurance fund. Additionally, some have also stated that mixing banking and commerce could promote the formation of very large conglomerate enterprises with substantial amounts of economic power. If these

institutions were able to dominate some markets, such as the banking market in a particular local area, they could impact the access to bank services and credit for customers in those markets.

Other industry observers have stated that there are potential benefits from mixed banking and commerce, including allowing banks, their holding companies, and customers to benefit from potential increases in the scale of operations, which lowers the average costs of production known as economies of scale, or from potential reductions in the cost of producing goods that share common inputs, known as economies of scope, and enhanced product and geographic diversification. Because banks incur large fixed costs when setting up branches, computer networks, and raising capital, these institutions may benefit from the selected economies of scale and scope that could result from affiliations with commercial entities. For example, we were told combined entities may be able to generate operating efficiencies by sharing computer systems or accounting functions. Mixed banking and commercial entities may also benefit from product synergies that result from affiliation. For example, firms engaged in both the manufacturing and financing of automobiles may be able to increase sales and reduce customer acquisition costs by combining manufacturing and financing. Other incentives for affiliations between banking and commercial firms include enhanced product and geographic diversification, which could contribute to reduced risk to the combined entity. Additionally, one FDIC staff wrote that increased mixing of banking and commerce may help U.S. banks with regard to global competition with several other countries that have fewer restrictions than the United States. Advocates have also stated that some of these potential revenue and cost synergies may be passed on to consumers through lower prices for banking or commercial services.

Divergent Views Exist About the Competitive Implications of Mixed Banking and Commerce

Continued market interest by commercial firms in mixed banking and commerce may indicate that at least some participants believe that operational efficiencies and cost synergies may be realized from mixing banking and commerce. For example, three of the six new ILC charters approved by FDIC after June 30, 2004, are owned by nonfinancial, commercial firms. Additionally, recent press reports and conversations we had with federal banking regulators indicate one of the nation's largest retailers has expressed continuing interest in owning an insured depository institution. However, during our search of academic and other literature, we were unable to identify any conclusive empirical evidence that documented operational efficiencies from mixing banking and commerce.

One primary factor in the lack of empirical evidence may be that, because of the policy generally separating banking and commerce, few institutions are available for study.

However, product synergies between banking and commercial firms may exist in certain industries. For example, several automobile manufacturers own or operate captive financing affiliates that generally provide credit to borrowers at competitive rates to facilitate the commercial holding company's efforts to sell automobiles. Some of these affiliates are insured depository institutions while others rely on the capital markets, their commercial holding companies, or banks for funding. Additionally, other regulators and practitioners noted that commercially affiliated insured depository institutions might benefit from access to existing commercial holding company or affiliate customers. For example, insured banks owned or affiliated with commercial firms may be able to attract deposits or potential credit card customers through targeted marketing to the commercial holding company or affiliate customers. Industry observers we spoke with also told us that commercially affiliated banks might benefit from stronger brand recognition and, in instances where banks are owned by retailers, the banks may benefit from being located in stores that keep longer hours of operation. Furthermore, as discussed previously, combined firms may generate efficiencies from the sharing of fixed costs, such as computer systems or accounting functions.

One OTS official and industry practitioners we talked with were less convinced of potential economic efficiencies from mixing banking and commerce and suggested that these firms might not have a competitive advantage over other businesses. For example, an OTS official we talked with provided us with instances where the commercial owners of insured banks operating under the "nonbank bank" exemption had subsequently sold their insured banking subsidiaries because these firms may not have been able to realize expected operational efficiencies from mixed banking and commerce. For instance, a published study we reviewed noted that, in the late 1980s, a large retailer's efforts to cross market its traditional product line and financial services failed to generate expected synergies. The study highlighted the management challenges associated with linking the conglomerate's insurance, securities, real estate, retail, and catalog businesses. The study also mentioned difficulties managing accurate customer information and division management concerns about other divisions pursuing their customers as reasons for the conglomerate's inability to capture expected synergies. Further, the study noted the financial services centers operating inside the traditional retailer's stores

generally proved unprofitable. Eventually, the retailer cited in the study abandoned its diversification strategy and sold its financial services business. Similarly, a practitioner we spoke with stated that success in the banking industry may require skill sets that are different from the expertise and business practices in commercial sectors of the economy.

While there is little direct research assessing the competitive effects of mixing banking and commerce, the incentives to mix banking and commerce may in some way be linked to research indicating that operational efficiencies may result from merging two banks. According to this research, there is a general expectation that operational efficiencies may be realized from scale and scope economies within the banking industry. For example, merging two banks can result in gains from the closing of redundant branches, consolidating systems and back offices, and marketing products, such as credit cards, to broader customer bases. Some of these same operational efficiencies—such as the marketing of credit cards to a broader customer base—would presumably be available to mixed banking and commercial firms as well. However, empirical studies have not found clear evidence that bigger is necessarily better in banking. For example one study noted that while large banking operations were regarded as advantageous, the conclusions in academic literature on economies of scale and scope within merged banks are mixed. Our own independent review of academic literature reached similar conclusions. Some studies documented economies of scale and scope in banking, but others were less conclusive. Additionally, while some recent studies we reviewed suggested that recent advances in information technology may be contributing to greater opportunities for economies of scale and scope within the banking industry, these studies do not provide conclusive evidence on the competitive implications of mixing banking and commerce.

The mixed findings on scale and scope economies within academic literature we reviewed are in many ways consistent with market activity post GLBA. Because GLBA removed several restrictions on the extent to which conglomerates could engage in banking and nonbanking financial activities, such as insurance and securities brokerage, some analysts had expected that conglomeration would intensify in the financial services industry after GLBA. However, as yet, this does not seem to have happened. The reasons vary. Many banks may not see any synergies with insurance underwriting. Additionally, it may be that many mergers are not economically efficient, the regulatory structure set up under GLBA may not be advantageous to these mergers, or, it is simply too soon to tell what the

impact will be. Further, a general slowdown occurred in merger and acquisition activity across the economy in the early 2000s, which may also be a contributing factor to the pace of industry conglomeration post GLBA.

Recent Legislative Proposals May Increase the Attractiveness of Operating an ILC

FDIC-insured banks, including ILCs, are currently not permitted to offer interest-bearing business checking accounts. Recent legislative proposals would remove the current prohibition on paying interest on demand deposits and, separately, authorize insured depository institutions, including most ILCs, to offer interest-bearing business NOW accounts.[92] This would, in effect, expand the availability of products and services that insured depository institutions, including those ILCs, could offer. ILC advocates we spoke with highlighted that including ILCs in these legislative proposals maintains the current relative parity between ILC permissible activities and those of other insured bank charters. However, Board officials and some industry observers we spoke with told us that granting grandfathered ILCs the ability to offer business NOW accounts represents an expansion of powers for ILCs, which could further blur the distinction between ILCs and traditional banks. Another legislative proposal, introduced but not passed in the last congressional session, would allow banks and most ILCs (those included in a grandfathered provision) to branch into other states through establishing new branches—known as de novo branching—by removing states' authority to prevent them from doing so.[93] Board officials we spoke with told us that, if enacted, these proposals could increase the attractiveness of owning an ILC, especially by private sector financial or commercial holding companies that already operate existing retail distribution networks.

As previously discussed, in order to remain exempt from the definition of a bank under the BHC Act, most ILCs may not accept demand deposits, if their total assets are $100 million or more. However, ILCs are not restricted from offering NOW accounts, which are insured deposits that, in practice, are similar to demand deposits. Current federal banking law prohibits insured depository institutions from paying interest on demand deposits and does not authorize insured depository institutions to offer NOW

[92]See H.R. 1224, 109th Cong. § 3 (2005).

[93]H.R. 1375 108th Cong. § 401(b) (2004). This bill would permit de novo interstate branching by ILCs subject to the grandfathering provisions described later in our discussion of legislative proposals to permit interest-bearing business checking accounts.

business checking accounts. According to a Treasury official, the prohibition on paying interest on demand deposits, including those maintained by businesses, was enacted in the 1930s because of concerns about the solvency of the nation's banks and the belief that limiting competition among banks would reduce bank failures. This ban was designed to protect small rural banks from having to compete for deposits with larger institutions that could offer higher interest rates and use the deposits to make loans to stock market speculators and deprive rural areas of financing.

There have been repeated legislative proposals to repeal this prohibition. Supporters of these efforts have stated that the prohibition on paying interest on demand deposits, including those maintained by businesses, is an unnecessary and outdated law that unfairly affects small businesses. According to these supporters, small businesses tend to bank at smaller institutions that do not offer sweep accounts which, in effect, circumvent the ban on interest bearing demand accounts, because their deposit balances may not qualify for these accounts at larger institutions.[94] The most recent legislative proposals would repeal section 19(i) of the Federal Reserve Act and section 18(g) of the FDI Act, which, together with other federal laws, effectively prohibit the payment of interest on demand deposits, including business checking accounts.[95] This would allow insured depository institutions to pay interest on their demand deposits, including those maintained by businesses, although it would not remove the BHC Act provision exempting larger ILCs from the definition of a bank on the condition, among others, that they do not accept demand deposits. Separate provisions of this legislative proposal would allow qualified ILCs (which would include ILCs owned or controlled by a commercial firm where the ILC obtained deposit insurance prior to October 1, 2003, and did not undergo a change in control after September 30, 2003) to offer business NOW accounts. Going forward, other ILCs could offer business NOW accounts, provided that their state supervisors determine that at least 85% of their holding company and affiliated entities' gross revenues were from activities that were financial in nature or incidental to a financial activity in at least three of the prior four calendar quarters. In effect, this amendment would make it difficult for nongrandfathered ILCs owned by commercial

[94]Generally, sweep accounts use computers to analyze customer accounts and automatically transfer funds at the end of each day to higher-interest earning money market accounts.

[95]H.R. 1224 § 3. See 12 U.S.C. §§ 371a, 1828(g), 1832.

enterprises to offer interest bearing business NOW accounts. ILC advocates we spoke with highlighted that if other insured banks are permitted to offer interest bearing demand deposit accounts to businesses, granting ILCs the ability to offer interest bearing business NOW accounts maintains the current relative parity between ILC permissible activities and those of other insured bank charters. Officials at the Board have opposed ILCs being able to offer interest bearing business NOW accounts, unless ILC holding companies were subjected to consolidated supervision and the same activity restrictions applied to the holding companies of most other insured depository institutions, because doing so would further enable ILCs to become the functional equivalent of full-service banks and expand their operations beyond the historical function of ILCs and the terms of their exemption in current banking law.

Federal banking law permits insured state banks and ILCs to expand on an interstate basis by acquiring another institution, provided that state law does not expressly prohibit an interstate merger.[96] However, banks and ILCs are not permitted to branch in another state without having an established charter in that state and without acquiring another bank–known as de novo branching—unless the host state enacted legislation that expressly permitted this practice.[97] Currently, only 17 states have enacted this legislation. According to proponents of de novo branching, current restrictions make it difficult for small banks seeking to operate across state lines and puts banks at a disadvantage compared with savings associations, which are permitted to establish interstate de novo branches. A proponent also stated that de novo branching would benefit small banks near state borders to better serve customers by establishing new branches across state lines and would increase competition by providing banks with a less costly method for offering their services in new locations.

According to a Utah state bank supervisory official we spoke with, ILCs in some states have the ability to establish branches in certain other states through reciprocal branching agreements. For example, this official stated that ILCs in Utah have reciprocity agreements with 17 other states and are able to branch, without federal de novo branching authority, into these 17 states. However, this Utah state supervisory official and industry practitioners told us that many ILC business models do not rely on retail

[96]See 12 U.S.C. §§ 1831u.

[97]See 12 U.S.C. § 1828(d).

branching to conduct their business operations. For example, currently only two Utah ILCs have branches, and they have only two branches each. According to Board officials, granting ILCs unrestricted de novo branching authority in other states may increase the relative attractiveness of ILCs as compared with other financial institution charters. These officials highlighted that reduced restrictions on nationwide branching may increase private sector interest in ILC ownership by financial or commercial holding companies that operate retail distribution networks. However, according to at least one industry expert we spoke with, the effects of the consequences of de novo branching may be overstated and not likely to result in major changes in the ILC industry.

Conclusions

ILCs have significantly evolved from the small, limited purpose institutions that existed in the early 1900s. In particular, the ILC industry has grown rapidly since 1999 and, in 2004, six ILCs were among the 180 largest financial institutions with $3 billion or more in total assets, and one institution had over $66 billion in assets. Because of the significant recent growth and complexity of some ILCs, the industry has changed since being granted an exemption from consolidated supervision in 1987, and some have expressed concerns that ILCs may have expanded beyond the original scope and purpose intended by Congress.

The vast majority of ILCs have corporate holding companies and affiliates and, as a result, are subject to similar risks from holding company and affiliate operations as banks and thrifts and their holding companies. However, unlike bank and thrift holding companies, most ILC holding companies are not subject to federal supervision on a consolidated basis. Although FDIC has supervisory authority over an insured ILC, it does not have the same authority to supervise ILC holding companies and affiliates as a consolidated supervisor. While the FDIC's authority to assess the nature and effect of relationships between an ILC and its holding company and affiliates does not directly provide for the same range of examination authority, its cooperative working relationships with state supervisors and ILC holding company organizations, combined with its other bank regulatory powers, has allowed the FDIC, under limited circumstances, to assess and address the risks to the insured institution and to achieve other results to protect the Fund against ILC-related risks. However, we are concerned that insured institutions providing similar risks to the Fund are not being overseen by bank supervisors that possess similar powers.

FDIC has responded appropriately to the challenges it faces supervising the ILC industry by implementing significant enhancements to its examiner guidance designed to mitigate the risks that could be posed to insured depository institutions, including ILCs, from various sources, such as holding companies and affiliates. Within the scope of its authority, FDIC has demonstrated that its supervisory approach has, in some instances, effectively mitigated losses to the Fund. Some have even stated that, from a safety and soundness perspective, FDIC's approach is an effective alternative to the Board's bank holding company supervision, given that FDIC has successfully mitigated losses to the Fund posed by some troubled institutions. However, the Board disagrees and stated that FDIC's approach, without the aid of consolidated supervision, cannot effectively assess all the risks to a depository institution posed by the holding company and affiliates of an ILC. Moreover, the extent of some of FDIC's authorities over ILC holding companies and affiliates is not clear. For example, it is unclear under what circumstances FDIC could compel ILC affiliates to provide information about their operations when these affiliates do not have a relationship with an ILC. As a result, absent a cooperative working relationship, FDIC's supervisory approach may not be able to identify or address all potential risks to the insured institution. It is also unclear how effective the FDIC's approach would be if the ILC industry incurred widespread and significant losses or if a large complex ILC were to become troubled. As a result of differences in supervision, we and the FDIC-IG have found that, from a regulatory standpoint, ILCs in a holding company structure may pose more risk of loss to the Fund than other types of insured depository institutions in a holding company structure.

Although federal banking law may allow ILC holding companies to mix banking and commerce to a greater extent than holding companies of other types of depository institutions, we were unable to identify any conclusive empirical evidence that documented operational efficiencies from mixing banking and commerce, and the views of bank regulators and practitioners were mixed. Including ILCs in recent legislative proposals to offer business checking accounts and operate de novo branches nationwide maintains the current relative parity between ILC permissible activities and those of other insured bank charters. These legislative proposals may make the ILC charter more attractive and encourage future growth. However, the potential risks from combining banking and commercial operations remain, including the potential expansion of the federal safety net provided for banks to their commercial entities, increased conflicts of interest within a mixed banking and commercial conglomerate, and increased economic

power exercised by large conglomerate enterprises. In addition, we find it unusual that this limited exemption for ILCs would be the primary means for mixing banking and commerce on a broader scale than afforded to the holding companies of other financial institutions. Because it has been a long time since Congress has broadly considered the potential advantages and disadvantages of mixing banking and commerce and given the rapid growth of ILC assets and the potential for increased attractiveness of the ILC charter, it would be useful for Congress to review the ILC holding company's ability to mix banking and commerce more than other types of financial institutions and whether the holding companies of other financial institutions should be permitted to engage in this level of activity.

Matters for Congressional Consideration

Consolidated supervision is a recognized method of supervising an insured institution, its holding company, and affiliates. While FDIC has developed an alternative approach that it claims has mitigated losses to the bank insurance fund, it does not have some of the explicit authorities that other consolidated supervisors possess, and its oversight over nonbank holding companies may be disadvantaged by its lack of explicit authority to supervise these entities, including companies that own large and complex ILCs. To better ensure that supervisors of institutions with similar risks have similar authorities, Congress should consider various options such as eliminating the current exclusion for ILCs and their holding companies from consolidated supervision, granting FDIC similar examination and enforcement authority as a consolidated supervisor, or leaving the oversight responsibility of small, less complex ILCs with the FDIC, and transferring oversight of large, more complex ILCs to a consolidated supervisor.

The long-standing policy of separating banking and commerce has been based primarily on mitigating the potential risk that combining these operations may pose to the Fund and the taxpayers. GLBA reaffirmed the general separation of banking from commerce and providing financial services from nonfinancial commercial firms. However, under federal banking law, the ILC charter offers commercial holding companies more opportunity to mix banking and commerce than other insured depository institution charters. Congress should also be aware of the potential for continued expansion of large commercial firms into the ILC industry—especially if ILCs are granted the ability to de novo branch and offer interest bearing business checking accounts. In recent years, this policy issue has been addressed primarily through exemptions and provisions to existing laws rather than assessed on a comprehensive basis. Thus,

Congress should more broadly consider the advantages and disadvantages of mixing banking and commerce to determine whether continuing to allow ILC holding companies to engage in this activity more than the holding companies of other types of financial institutions is warranted or whether other financial or bank holding companies should be permitted to engage in this level of activity.

Agency Comments and Our Evaluation

We provided a draft of this report to the Board, FDIC, OTS, and SEC for review and comment. Each of these agencies provided technical comments that were incorporated as appropriate. In written comments, the Chairman of the Board of Governors of the Federal Reserve System (see app. II) concurred with the report's findings and conclusions. Specifically, the Chairman stated that "consolidated supervision provides important protections to the insured banks that are part of a larger organization, as well as the federal safety net that supports those banks." The Chairman also wrote that our report "properly highlights the broad policy implications that ILCs raise with respect to maintaining the separation of banking and commerce."

In written comments from the Chairman of the Federal Deposit Insurance Corporation (see app. III), FDIC concurred with one of the report's findings but generally believed that no changes were needed in its supervisory approach over ILCs and their holding companies and disagreed with the matters for congressional consideration. Specifically, the FDIC concurred that from an operations standpoint, ILCs do not appear to have a greater risk of failure than other types of insured depository institutions. However, FDIC's disagreements generally focused on three primary areas—whether consolidated supervision of ILC holding companies is necessary to ensure the safety and soundness of the ILC; that FDIC's supervisory authority may not be sufficient to effectively supervise ILCs and insulate insured institutions against undue risks presented by external parties; and the impact that consolidated supervision of ILCs and their holding companies would have on the marketplace and the federal safety net.

First, in its comments about consolidated supervision for ILCs and their holding companies, FDIC stated that its bank-centric supervision, enhanced by sections 23A and 23B of the Federal Reserve Act and the Prompt Corrective Action provisions of the FDIC Improvement Act, is a proven model for protecting the deposit insurance funds, and no additional layer of consolidated federal supervision of ILC holding companies is necessary. As stated in our report, we agree that FDIC's approach has

effectively mitigated the risk of loss to the Fund in some instances. However, FDIC's approach has only been tested on a limited basis in relatively good economic times. FDIC also expressed concern that our report did not include a comparison of the effectiveness and cost of FDIC's bank-centric approach with the effectiveness and cost of consolidated supervision. As stated in our report, the scope of this review did not include an assessment of the extent to which regulators effectively implemented consolidated supervision or any other type of supervision. Rather, we focused on the respective regulators' authorities to determine whether there were any inherent limitations in these authorities. Consolidated supervision is widely recognized nationally and throughout the world as an accepted approach to supervising organizations that own or control financial institutions and their affiliates, and we are not aware of any empirical evidence, or a reliable method of gathering such evidence, that could be used to draw meaningful conclusions about the costs and benefits of either supervisory approach. Further, during our review we did not become aware of any significant concerns over the cost of consolidated supervision. While we recognize that consolidated supervision would likely pose some additional cost to ILC holding companies, determining the extent of this cost would be speculative, depending on the scope of coverage of consolidated supervision (including whether current ILC parents would be grandfathered or whether ILCs below some size threshold would be exempt). Further, we believe that as one considers any additional costs, consideration should also be given to the benefits obtained from the enhanced supervisory tools and authorities that ILC regulators could use to better protect the Fund.

Further, FDIC believes that no additional layer of consolidated federal supervision of ILC holding companies is necessary and asserts that the report inappropriately repeated assertions by the Board which speculated that excessive debt at the parent of Pacific Thrift and Loan (PTL), an ILC, caused PTL to engage in higher-risk strategies that resulted in the ILC's failure. FDIC further stated that these assertions were not supported by the FDIC-IG's material loss review. We disagree that the information presented in the report is not supported by the FDIC-IG's review of PTL. As we report, the IG did not specifically identify PTL's excessive debt as a cause of failure. The IG found that inappropriate valuation of PTL's residual assets (i.e., the assets that PTL retained after it packaged and sold loans) ultimately caused the collapse of the bank. As FDIC notes, it and the other bank regulators have subsequently tightened rules for this valuation. However, the collapse of PTL was not purely an issue of inappropriate accounting. The IG found that while PTL's parent "was incurring

monumental amounts of debt, no federal agency was present to regulate these activities. The major problem with the borrowing arrangement was whether or not [the parent] had the financial wherewithal to repay the debt on a stand-alone basis without relying on PTL for financial support." The IG's report also stated that PTL's new "management team immediately implemented an expansionary program of originating and selling subprime mortgage loans...without regard to adequate policies, programs, and controls [which] resulted in serious shortcomings." We believe that one of the significant benefits of consolidated supervision is that it may better position a regulator to obtain an earlier awareness of possible problems within a holding company structure that could have an impact on the insured bank than does the FDIC's bank-centric approach. Had there been a greater regulatory presence at the holding company, potentially, problems at PTL may have been identified earlier or averted. Further, the Board's view of all of the contributing factors to PTL's failure is necessary to have a balanced discussion of this event.

Second, FDIC commented that it does not need any additional supervisory authority and has an excellent track record of identifying potential problems at nonbank subsidiaries and taking appropriate corrective action. FDIC further stated that the report too narrowly interpreted its examination authority. We agree that within the scope of its authority, FDIC has demonstrated that its supervisory approach has, in some instances, effectively mitigated losses to the Fund. However, we disagree that the report narrowly interprets FDIC's various authorities and continue to believe that consolidated supervision offers broader examination and enforcement authorities that may be used to understand, monitor, and, when appropriate, restrain the risks associated with insured depository institutions in a holding company structure. Further, as stated in the report, consolidated supervisors can compel holding companies and nonbank subsidiaries to provide key financial and operational reports and can impose consolidated or parent-only capital requirements that are important tools used to help ensure the safety and soundness of an insured depository institution. We continue to be concerned that FDIC's bank-centric approach relies on voluntary participation by regulated and unregulated entities to provide this key information, and that this approach has only been tested during a favorable economic environment. The ILC industry is growing rapidly and some ILCs are becoming increasingly complex. Thus, we believe it is important for the Congress to consider whether insured institutions providing similar risks to the Fund should also be overseen by bank supervisors that uniformly possess similar powers.

Third, in its comments, FDIC also stated that consolidated supervision of ILCs and their holding companies would result in greater federal involvement with commercial parents and nonbank subsidiaries. While we agree that more commercial entities would be subject to federal oversight, we disagree with FDIC's comment that such oversight "would represent a new level of government intrusion in the marketplace" and would "radically restructure" the federal government's role relative to commercial firms. Subjecting commercial ILC holding companies to consolidated supervision currently would affect a relatively small number of firms that chose to own and operate ILCs and provide them with a similar level of oversight afforded to other firms owning insured depository institutions. In so doing, consolidated supervision could better ensure that there is sufficient regulatory authority to effectively supervise these entities. Our report, however, raises oversight concerns with not only commercial holding company ownership of ILCs, but also discusses the development of a small number of more complex ILCs owned by financial-oriented holding companies that are currently exempt from consolidated supervision. At this time, it is more so because of the advent of these larger institutions—which increases the potential risk to the Fund—rather than commercial ownership of ILCs, that we believe this lack of consolidated supervision merits additional congressional scrutiny.

FDIC further stated that such supervision may call into question the individual accountability of insured institutions owned by large organizations to manage their own capital and could lead to an unintended expansion of the federal safety net to these entities. We disagree that consolidated supervision would have this effect since many institutions currently manage their capital, and regulators assess its adequacy on a consolidated basis. Further, the report does not advocate an expansion of the federal safety net. Rather, this report advocates that ILCs and their holding companies be regulated in a similar manner as other insured depository institutions and their holding companies.

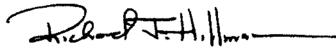
Historically, limited charter entities such as ILCs and nonbank banks were exempt from consolidated supervision. However, ILCs have evolved from small, limited purpose institutions and are exempt from business activity limitations that generally apply to the holding companies and affiliates of other FDIC-insured depository institutions offering similar services. Further, ILCs may provide a greater means for mixing banking and commerce than ownership of or affiliation with other insured depository institutions. Given the changes and growth in the ILC industry, we see less distinction now between ILC holding companies and other holding

companies owning insured depository institutions, and it is unclear why a different regulatory approach would be used to supervise ILCs. As a result, we continue to believe that Congress should consider various options such as eliminating the current exclusion for ILCs and their holding companies from consolidated supervision, granting FDIC similar examination and enforcement authority as a consolidated supervisor, or leaving the oversight responsibility of small, less complex ILCs with the FDIC, and transferring oversight of large, more complex ILCs to a consolidated supervisor.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time we will send copies of this report to the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs; Chairman and Ranking Minority Member of the House Committee on Banking, Housing, and Urban Affairs; and other congressional committees. We also will send copies to the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Securities and Exchange Commission, and make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

This report was prepared under the direction of Dan Blair, Assistant Director. If you or your staff have any questions regarding this report, please contact me at (202) 512-8678 or hillmanr@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors are acknowledged in appendix IV.

Sincerely yours,



Richard J. Hillman
Managing Director, Financial Markets
and Community Investment

Objectives, Scope, and Methodology

To describe the history and growth of the industrial loan corporation (ILC) industry, we analyzed Federal Deposit Insurance Corporation (FDIC) Call Report and Statistics on Depository Institutions (SDI) data on ILCs including total assets and estimated insured deposits from 1987 through 2004 to determine the (1) number of ILCs by year and by state, (2) total ILC industry assets by year and by state, and (3) ILC industry estimated insured deposits as a percentage of total estimated insured deposits by year. Prior to using the Call Report and SDI data, we assessed its reliability by (1) reviewing existing information about both data systems (2) interviewing agency officials knowledgeable of both data systems to discuss the sources of the data variables and the controls in place to ensure the accuracy and integrity of the data, and (3) performing various electronic tests of the required data elements. Based on our work, we determined that the data from both the Call Report and SDI systems were sufficiently reliable for the purposes of this report.

To describe the permissible activities and regulatory safeguards for ILCs as compared with state nonmember banks, we reviewed federal and state legislation, regulations, and other guidance regarding ILCs and banks. We interviewed state bank regulators from the Utah Department of Financial Institutions, the California Department of Financial Institutions, and the Nevada Financial Institutions Division. We focused on ILCs and regulators in these three states because over 99 percent of the ILC industry assets exist in these states. We also interviewed key management officials of various ILCs in these states that were representative of the various sizes and business strategies, including: large businesses with activities that were predominantly within the financial services sector; businesses that were primarily credit card operations; captive financing arms of commercial holding companies; and a small, community-oriented banking institution. In addition, we interviewed management officials from the headquarters of FDIC, as well as field staff from FDIC's San Francisco Regional Office and the FDIC Salt Lake City Field Office that are responsible for the supervision of ILCs located in California, Nevada, Utah, and other states. We also interviewed officials from the Board of Governors of the Federal Reserve (Board).

To compare FDIC's supervisory authority over ILC holding companies and affiliates with the consolidated supervisors' authority over holding companies and affiliates, we analyzed legislation and regulations that govern the supervision of insured depository institutions, including ILCs and their holding companies, banks and their holding companies, and thrifts and their holding companies. We focused our comparison from a

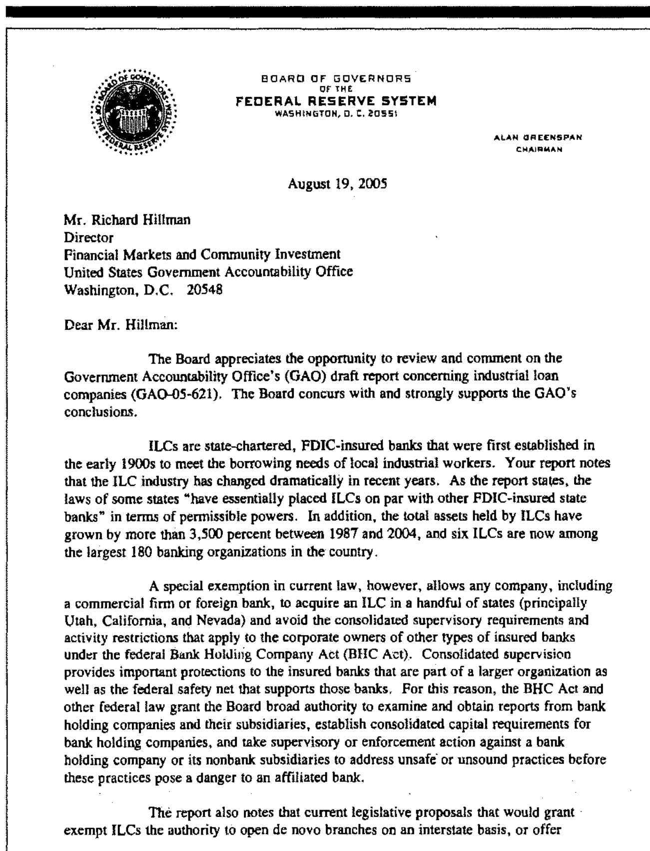
safety and soundness perspective primarily on the Board's consolidated supervision of bank holding companies and their affiliates because these entities may pose similar risks to insured depository institutions as ILCs that exist in a holding company structure. However, because the Office of Thrift Supervision (OTS) also supervises similar entities that pose similar risks to insured depository institutions, we also reviewed OTS' supervisory authority. We also interviewed state banking regulators in California, Nevada, and Utah, as well as officials headquartered in the offices of the FDIC, the Board, and OTS who are knowledgeable of the supervisory approach and authorities of these agencies.

To determine recent changes FDIC has made to its supervisory approach for the risks that holding companies and affiliates could pose to ILCs and whether differences in supervision and regulatory authorities pose additional risk to the Fund, we interviewed knowledgeable FDIC officials and obtained documentation regarding revised agency guidance on safety and soundness examination procedures. We also compared agency examination manuals and other guidance; interviewed agency officials regarding the supervisory approach and supervisory authority of FDIC, the Board and OTS; and spoke with state and FDIC regional staff responsible for conducting examinations. Additionally, we synthesized and relied, as appropriate, upon information from the FDIC Inspector General (FDIC-IG) September 30, 2004, report entitled, *The Division of Supervision and Consumer Protection's Approach for Supervising Limited-Charter Depository Institutions* because this report provided information on FDIC's guidance and procedures for supervising limited charter depository institutions, including ILCs, and summarized various recent actions that FDIC had taken. Prior to relying on the FDIC-IG's report, we performed various due diligence procedures that provided a sufficient basis for relying upon their work including obtaining information about the other auditors' qualifications and independence; reviewing the other auditors' external quality control review report; and determining the sufficiency, relevance, and competence of the other auditors' evidence by reviewing the audit report, audit program and documentation. We also reviewed and synthesized information from the FDIC-IG's material loss reviews of Pacific Thrift and Loan and Southern Pacific Bank, two failed ILCs. To determine what actions FDIC had taken as a result of these material loss reviews and any other conditions existing in the banking industry at that time, we interviewed FDIC management about the status of recommendations made by the FDIC-IG in the material loss reviews.

To determine whether ILCs allow for greater mixing of banking and commerce than other insured depository institutions and whether this possibility has any competitive implications, as well as to determine the implications of granting ILCs the ability to pay interest on business checking accounts and operate de novo branches nationwide, we reviewed and synthesized academic, bank regulator, and other studies and literature about the historic policy of mixing banking and commerce, potential economies of scale and scope in the banking industry, and academic literature on mixed banking and commerce in other countries. We also interviewed and reviewed studies from academics who have published on the subject of regulatory and competitive issues in the banking industry. Additionally, we reviewed applicable laws and legislative proposals, press reports, and other documents. Furthermore, we assessed the degree to which other depository institutions are able to mix banking and commerce, such as unitary thrifts, "nonbank banks," merchant banks, and captive finance subsidiaries. In addition, we reviewed applicable laws and regulations and interviewed federal banking regulators from the FDIC, Federal Reserve, and OTS. We also interviewed state banking regulators in Utah, California, and Nevada and key management officials from several ILCs in California, Nevada, and Utah, as well as representatives from the Independent Community Bankers Association.

Finally, to more fully understand (1) the significance of the differences between consolidated supervision of bank and thrift holding companies and FDIC's supervision of ILCs and the potential risks that their holding company and affiliate organizations may pose to the ILC, (2) the potential for greater mixing of banking and commerce by ILC holding companies as compared with other types of depository institutions, and (3) the potential advantages and disadvantages of granting ILCs the ability to pay interest on business checking accounts and open de novo branches nationwide, we hosted a panel of experts. The panel members were selected from a list of well-known and knowledgeable officials from the FDIC and the Board, academics, economists, industry practitioners, and independent consultants. The panel participants were selected to ensure a robust discussion of divergent views on issues facing the ILC industry and bank regulators.

Comments from the Board of Governors of the Federal Reserve System



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

August 19, 2005

Mr. Richard Hillman
Director
Financial Markets and Community Investment
United States Government Accountability Office
Washington, D.C. 20548

Dear Mr. Hillman:

The Board appreciates the opportunity to review and comment on the Government Accountability Office's (GAO) draft report concerning industrial loan companies (GAO-05-621). The Board concurs with and strongly supports the GAO's conclusions.

ILCs are state-chartered, FDIC-insured banks that were first established in the early 1900s to meet the borrowing needs of local industrial workers. Your report notes that the ILC industry has changed dramatically in recent years. As the report states, the laws of some states "have essentially placed ILCs on par with other FDIC-insured state banks" in terms of permissible powers. In addition, the total assets held by ILCs have grown by more than 3,500 percent between 1987 and 2004, and six ILCs are now among the largest 180 banking organizations in the country.

A special exemption in current law, however, allows any company, including a commercial firm or foreign bank, to acquire an ILC in a handful of states (principally Utah, California, and Nevada) and avoid the consolidated supervisory requirements and activity restrictions that apply to the corporate owners of other types of insured banks under the federal Bank Holding Company Act (BHC Act). Consolidated supervision provides important protections to the insured banks that are part of a larger organization as well as the federal safety net that supports those banks. For this reason, the BHC Act and other federal law grant the Board broad authority to examine and obtain reports from bank holding companies and their subsidiaries, establish consolidated capital requirements for bank holding companies, and take supervisory or enforcement action against a bank holding company or its nonbank subsidiaries to address unsafe or unsound practices before these practices pose a danger to an affiliated bank.

The report also notes that current legislative proposals that would grant exempt ILCs the authority to open de novo branches on an interstate basis, or offer

Mr. Richard Hillman
Page 2

interest-bearing checking accounts to business customers, would make it increasingly attractive for companies to establish ILCs, rather than other types of insured banks, and thus avoid consolidated supervision. In addition, because ILCs are exempt from the definition of "bank" in the BHC Act, a foreign bank may acquire an FDIC-insured ILC without meeting the requirement in the BHC Act that the foreign bank be subject to comprehensive supervision on a consolidated basis in its home country. Congress established this comprehensive, consolidated supervision requirement in 1991 for foreign banks seeking to enter the banking business in the United States following the collapse of Bank of Commerce and Credit International (BCCI).

Your report also properly highlights the broad policy implications that ILCs raise with respect to maintaining the separation of banking and commerce. Because Congress has closed the so-called "nonbank bank" and unitary thrift loopholes, the ILC exemption is now the primary means by which commercial firms may control an FDIC-insured bank engaged in broad lending and deposit-taking activities. We believe it is important for the Congress to decide, after a full and careful evaluation, whether broader mixings of banking and commerce should be allowed for all banking organizations, rather than allowing the nation's policy on banking and commerce to be decided de facto through the exploitation or expansion of an exemption available only to one type of institution chartered in certain states.

Board staff has separately provided GAO staff technical and correcting comments on the draft report. We hope that these comments are helpful.

Thank you again for your efforts on this important matter.

Sincerely,

Appendix III

Comments from the Federal Deposit Insurance Corporation

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington DC 20429

DONALD E. POWELL
CHAIRMAN

August 29, 2005

Mr. Richard Hillman, Director
Financial Markets and Community Investment
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Hillman:

Thank you for the opportunity to comment on the draft report entitled Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlights Differences in Regulatory Authority (GAO-05-621). Your report does not recommend executive action. However, we welcome this opportunity to respond to the report and address the Matters for Congressional Consideration that you have raised.

The Federal Deposit Insurance Corporation agrees with the report's finding that "from an operations standpoint, industrial loan corporations (ILCs) do not appear to have a greater risk of failure than other types of insured depository institutions." The report also documents the FDIC's legal and supervisory authorities to address risks to insured ILCs that may be posed by affiliated entities. The report nevertheless recommends that Congress consider strengthening (the report's term) the regulation of parent companies of ILCs by subjecting them to the same consolidated supervision as is currently applied to bank holding companies. The FDIC believes these suggested changes in regulation are unnecessary from a safety and soundness perspective, and would inappropriately change the relationship between the federal banking agencies and the non-bank sector of the U.S. economy.

As outlined in more detail in this letter, the FDIC does not believe that consolidated supervision of an ILC's corporate owner is necessary to ensure the safety and soundness of the ILC itself. The FDIC disagrees with the GAO's finding that our regulatory authorities may not be sufficient to effectively supervise, regulate, or take enforcement action to insulate insured institutions against undue risks presented by external parties. We believe the GAO's finding is founded on a misinterpretation of the legal basis underlying the regulatory authorities of both the FDIC and the Federal Reserve Board of Governors (Federal Reserve). The core of each banking agency's statutory mandate for supervision is preserving the safety and soundness of insured depository institutions. We believe the record shows the FDIC's authorities are as effective in achieving this goal as are the authorities of consolidated supervisors.

The FDIC also believes consolidated supervision of ILC parents would change the relationship between the federal banking agencies and the non-bank sector of the U.S. economy in undesirable ways. This includes the potential for an unintended expansion of the federal

banking safety net, and the costs of imposing bank-like regulation on a greater share of U.S. economic activity. The GAO bases its recommendations in part on the idea that ILCs benefit from an uneven competitive playing field, since their parent companies are not subject to the same type of consolidated supervision that applies to other corporate owners of insured banks. As noted by a number of panelists at a symposium the GAO convened to assist in the preparation of this report, however, there are reasons why commercial and other non-bank owners of insured banks should not be subject to consolidated banking agency supervision. Commercial firms and entities such as broker-dealers are, and should remain, outside the scope of the federal banking safety net. Imposing activity restrictions and other aspects of bank-like regulation on firms that historically have not been subject to such regulation has costs, and these costs need to be weighed against any perceived safety-and-soundness benefits to insured entities.

The necessity of consolidated federal supervision of all large conglomerates that own banks is a new idea. In March, 1997, Federal Reserve Chairman Alan Greenspan told Congress:

> ...we would hope that should the Congress authorize wider activities for financial services holding companies that it recognize that a bank, which is a minor part of such an organization (and its associated safety net), can be protected through adequate bank capital requirements and the application of Sections 23A and 23B of the Federal Reserve Act. The case is weak, in our judgment, for umbrella supervision of a holding company in which the bank is not the dominant unit and is not large enough to induce systemic problems should it fail.1 [Emphasis added].

More recently, proponents of consolidated supervision appear to have moved away from the views expressed by Chairman Greenspan and toward a more absolute claim that the safety and soundness of an insured financial institution requires the consolidated, top-down supervision of its corporate owner. This approach, which the GAO endorses, is based on the idea that supervisors should mirror business processes used in the private sector. Enterprise risk management processes, used by a number of large banking organizations, are characterized by a centralized approach to risk management throughout the conglomerate. Enterprise risk management, as used in these firms, is essentially a tool to better manage private profits and safeguard the interests of holding company shareholders. However, its use as a model on which federal bank supervisors would base their efforts to safeguard individual insured banks within large conglomerates is as yet unproven. Indeed, by appearing to promote the operation of insured entities in conglomerates more as integrated parts of a broader organization, and less as insulated entities, consolidated supervision going forward could have the unintended effect of extending the scope of the safety net, rather than containing it.

For these reasons, the FDIC believes that a supervisory approach that focuses on insulating the insured financial institution and the federal safety net from external risks (the bank-centric approach) is an appropriate supervisory model for ILCs and their parent companies.

[1] Testimony of Chairman Alan Greenspan before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the Committee on Banking and Financial Services, U.S. House of Representatives, March 19, 1997.

The remainder of this letter provides further discussion of the track record of supervision, the practical significance of differences in agencies' supervisory authorities, certain issues related to banking agency supervision of commercial firms, and the scope of the federal banking safety net.

The Track Record of Supervision

Surprisingly, in recommending one mode of supervision over another, the report attempts no comparison of how these methodologies have fared in protecting the deposit insurance funds, or their relative costs and benefits. Not only does the report attempt no systematic study of these issues, it ignores opportunities for relevant comparisons. For example, while acknowledging that the FDIC successfully insulated from failure the insured ILC of a large, bankrupt, commercial parent company, the report does not provide similar examples where a large bank holding company failed without any losses to its insured subsidiaries.

In the absence of any factual comparison of how various models of holding company supervision have fared in protecting the deposit insurance funds, the GAO report looks to a single ILC failure, Pacific Thrift and Loan (PTL), and repeats assertions by representatives of the Federal Reserve who speculate that excessive debt at PTL's parent caused the bank to engage in higher-risk strategies that resulted in the bank's failure. The assertions, however, are not supported by the FDIC Inspector General's Material Loss Review finding that, "PTL's overly optimistic valuation assumptions resulted in inflated values that were unrealizable." PTL did not fail as a result of parent company debt, and neither the Federal Reserve nor the GAO presents any evidence that an examination of the parent company by a consolidated supervisor would have prevented the failure of this insured institution. The Federal Reserve's assertions in this case are all the more surprising in view of the fact that it joined the FDIC and other bank regulators in responding to the failure of PTL and other non-ILC institutions by tightening the rules for valuations of residual assets, not by taking any action to address problems with excessive parent company debt.

The FDIC believes that bank-centric supervision, as applied by the National Bank Act and the FDI Act, and enhanced by Sections 23A and 23B of the Federal Reserve Act and the Prompt Corrective Action provisions of the FDIC Improvement Act, is a proven model for protecting the deposit insurance funds, and no additional layer of consolidated federal supervision of ILC parents is necessary.

The Legal Authority for Supervision

The FDIC's supervisory philosophy of insulating the insured ILC, bank, or thrift, is rooted in the absolute accountability of insured institution boards of directors for the governance of their institutions. Transaction testing at the insured entity, traced as needed through parent companies and affiliates, is intended to ensure that undue parent company influence is not being exercised. Important bank functions are evaluated onsite, whether at the bank or, where those functions are outsourced to affiliates, at those entities. Identifying and addressing inappropriate influence by affiliated entities is included in the scope of every examination, but the degree of insulation the FDIC requires increases substantially as identified risk increases, and can reach the

point where the bank is completely walled off from its affiliates with all major decisions requiring FDIC approval.

One of the central themes of the report is that the FDIC's authority to examine an affiliate of an insured depository institution is so restricted that reputation risk from an affiliate that has no direct relationship with the ILC could go undetected. Contrary to GAO's legal interpretation, the FDIC's affiliate examination authority is not dependent upon the existence of any particular kind of relationship, nor is it limited to discrete transactions between an ILC and its affiliate. The FDIC does not agree that its examination authority is properly interpreted so narrowly. In actual application, even in problem-institution or failure cases, the FDIC has always been able to exercise its examination authority broadly enough to fulfill its supervisory duties.

The GAO report points to perceived limitations on the FDIC's supervisory authority that might prevent it from exercising authority over certain non-banking affiliates. Yet, a careful reading of the report reveals that the authorities of consolidated supervisors are subject to almost identical limitations. Furthermore, the GAO report acknowledges an additional power available to the FDIC alone: "[a]s demonstrated by the number of institutions that took measures to enhance the safety and soundness of the insured depository institution, the threat of insurance termination has been an effective supervisory measure in many instances."

Whether in the case of a consolidated supervisor or the FDIC, the financial institution supervisor must rely on knowledge of a potential problem at a non-bank subsidiary and have some reason to believe that problem may adversely affect the insured depository institution before the supervisor can take direct action. The FDIC has an excellent track record of doing so even without the consolidated supervisory powers itemized in the report. In terms of the relevant goal of safeguarding the federal banking safety net, any conclusion that the FDIC's affiliate examination authority is less effective in practice than that of consolidated supervisors is not supported by the historical record.

Issues Associated with Banking-Agency Supervision of Commercial Enterprises

Consolidated supervision implies that a federal banking regulator would oversee the commercial parent and its affiliates, and that commercial activities increasingly would be subject to regulation designed for banks. The potential result of implementing the GAO's recommendation would be that federal banking regulators may exercise supervisory oversight over large sectors of the U.S. economy. This would represent a new level of government intrusion in the marketplace – in fact, it would amount to a radical restructuring of the longstanding role of the federal government relative to commercial firms. Such an approach also would raise significant concerns about legal separateness, corporate governance, and the unwarranted expansion of the federal safety net.

It should also be noted that consolidated supervision of a large, commercial organization is subject to certain practical constraints. The legal structures of many of these companies are intentionally segregated, with some large companies having hundreds of subsidiaries. Many financial holding companies are similarly diverse. An individual review of each subsidiary would be extremely time-consuming and would be unlikely to yield information useful to the

effective supervision of the subsidiary bank. As a result, consolidated supervisors have tended to focus on a high-level review as the only time-effective, practical approach to the supervision of these entities. The argument that consolidated supervision of a company such as General Electric would benefit bank regulators by improving familiarity with a non-bank affiliate, such as the consumer electronics division of the company, is not compelling from either a logistical or a risk identification standpoint.

The Consolidated Supervision Approach May Extend the Federal Safety Net

In the United States, the federal safety net is provided to insured banks, not their holding companies and affiliates. Preventing the federal safety net from supporting risks taken outside insured banks has been the most often-stated reason for the existence of bank holding company supervision.

Recently, however, the Federal Reserve endorsed the concept of enterprise-wide supervision, founded on the principle that government supervision must mirror the manner in which companies are managed. The FDIC is concerned that some aspects of this new supervisory approach may detract from achieving the traditional goal of preventing insured entities from supporting risks taken in parents or affiliates. Under an enterprise-wide supervision approach, it appears that the supervisory vision of an insured bank as an independent entity may be supplanted by a supervisory vision of an insured bank as an integrated component of a larger organization. Enterprise supervision by holding company management, and the top-down approach to Basel II advocated by the Federal Reserve, have the potential to call into question the individual accountability of insured institutions owned by large organizations to manage their own capital.

A supervisory goal of insulating an insured bank from risks taken by an affiliate is fundamentally different from a supervisory goal of integrating that bank with its affiliates. Integration downplays the risk-management responsibilities of insured entities operating in financial conglomerates. A supervisory regime that in any way supports the idea that insured banks are not fully accountable for their own risk management, combined with a capital regime that promotes the concept that an insured institution's risk should be measured together with its affiliates, effectively expands the federal safety net.

The regulatory approach of the FDIC focuses on the insured entity and the importance of maintaining corporate separateness. The consolidated supervision model proposed by the GAO for consideration by Congress not only endangers these legal-entity distinctions, but also raises the possibility of extending the federal safety net beyond the insured entity. To the extent banks are integrated and managed as departments of their holding company, especially if regulators by means of their supervisory methodology are actively promoting this approach, there is a danger that the bank could be held liable for the debts or conduct of an affiliate. This piercing of the corporate veil seems far more likely under an "integration" philosophy of supervision than it does under an "insulation" philosophy.

Conclusion

Congress must ensure that a financial regulatory framework is in place that adequately controls the potential cost of the federal banking safety net. This includes deciding how arrangements involving the ownership of banks by commercial firms should be regulated.

The GAO report articulated one vision of such regulation—consolidated banking agency supervision of the commercial parent. We are concerned with such an approach, and we believe the federal safety net is best protected in such situations by a bank-centric regulatory approach that focuses on bank insulation, corporate separateness, and the legal accountability of bank directors and officers.

The FDIC believes these issues will be an important subject for public policy debate in the years ahead. We stand ready to provide the GAO, Congress and other interested persons with any information we can in order to contribute to an appropriate resolution of these important questions.

Sincerely,

Donald E. Powell

GAO Contact and Staff Acknowledgments

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Richard J. Hillman (202) 512-8678

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Statement of

Scott G. Alvarez

General Counsel

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

October 4, 2007

Chairman Dodd, Ranking Member Shelby, and members of the Committee, I am pleased to appear today to provide the views of the Board of Governors of the Federal Reserve System on industrial loan companies (ILCs). The Board commends the Committee for holding this hearing and for considering ways of addressing the important public policy implications raised by the special exception for ILCs in federal law. The Committee is no stranger to the issues raised by the ILC exception. ILCs are state-chartered banks that have virtually all of the powers and privileges of other insured commercial banks, including the protections of the federal safety net--deposit insurance and access to the Federal Reserve's discount window and payments system. Nonetheless, ILCs operate under a special exception to the federal Bank Holding Company Act (BHC Act). This special exception allows any type of firm, including a commercial firm or foreign bank, to acquire and operate an ILC chartered in one of a handful of states without complying with the standards that Congress has established for bank holding companies to maintain the separation of banking and commerce and to protect insured banks, the federal safety net and, ultimately, the taxpayer.

We believe it is critical that Congress now consider and address the important public policy implications raised by the ILC exception, particularly in light of the dramatic recent growth and potential future expansion of banks operating under this special exception. Only Congress can craft a solution that addresses the full range of issues created by the ILC exception in a permanent, comprehensive and equitable manner. Your decisions on these matters also will influence the structure, soundness and resiliency of our financial system and economy.

The Board believes the best way to prevent this exception from further undermining the general policies that Congress has established and further promoting competitive and regulatory imbalances within the banking system is to *close* the loophole in current law to new acquirors of

ILCs. This is precisely the approach that Congress has taken on previous occasions when earlier loopholes began to be used in unintended and potentially damaging ways.

The ILC Exception and its Origins

The Board's concerns arise from the fact that the corporate owners of ILCs operate outside the prudential framework and statutory activity provisions that apply to all other corporate owners of full-service insured commercial banks. The BHC Act, originally enacted in 1956, provides a federal framework for the supervision and regulation of companies that own or control a bank and their affiliates. This comprehensive framework is intended to help protect the safety and soundness of corporately controlled banks that have access to the federal safety net and to maintain the general separation of banking and commerce in the United States. It does so principally in two ways. First, the act provides for all bank holding companies, including financial holding companies formed under the Gramm-Leach-Bliley Act (GLB Act), to be supervised on a consolidated or group-wide basis by the Federal Reserve. Second, the act prevents bank holding companies from engaging in general commercial activities. Instead, the act allows financial holding companies to engage only in activities that Congress or the Board (in consultation with the Treasury Department, in certain cases) has determined to be financial in nature or incidental or complementary to a financial activity. The act also requires as a condition for engaging in broad securities underwriting, insurance and other financial activities that the financial holding company maintain the financial and managerial strength and satisfactory Community Reinvestment Act (CRA) performance of its depository institution subsidiaries.[1]

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[1] Bank holding companies that do not meet these tests of strong capital and management and satisfactory CRA performance are permitted to engage only in a narrower range of activities that have been found to be "closely related to banking."

The ILC exception allows a company to acquire an insured bank chartered in one of a handful of states--principally Utah and California--outside this supervisory and regulatory framework. The special exception for ILCs was enacted in 1987. At that time, the size, nature and powers of ILCs were quite restricted. ILCs engaged primarily in making small loans to industrial workers and for many years generally were not permitted to accept deposits or obtain deposit insurance from the Federal Deposit Insurance Corporation (FDIC). As of year-end 1987, the largest ILC had assets of approximately $410 million and the average asset size of all ILCs was less than $45 million. The relevant states with ILCs also were not actively chartering new ILCs. At the time the exception was enacted, for example, Utah had only eleven state-chartered ILCs and had imposed a moratorium on the chartering of new ILCs. Moreover, interstate banking restrictions and technological limitations made it difficult for institutions chartered in an eligible state to operate a retail banking business regionally or nationally.

Changing Character and Nature of ILCs

What was once an exception with limited and local reach has now become the avenue through which large national and international financial and commercial firms have acquired federally insured banks and gained access to the federal safety net. Indeed, dramatic changes have occurred with ILCs in recent years that have made ILCs virtually indistinguishable from other FDIC-insured commercial banks. For example, in 1997, Utah lifted its moratorium on the chartering of new ILCs, allowed ILCs to call themselves banks, and authorized ILCs to exercise virtually all of the powers of state-chartered commercial banks. Since that time, Utah also has begun to charter new ILCs and to promote them as a method for companies to acquire a federally insured bank while avoiding the requirements of federal supervision and regulation under the BHC Act.

As a result of these and other changes, the aggregate amount of assets and deposits held by all ILCs operating under this exception increased substantially just in the nine years between 1997 and 2006, with assets increasing by more than 750 percent (from $25.1 billion to $212.8 billion) and deposits increasing by more than 1000 percent (from $11.7 billion to $146.7 billion). In fact, in 2006 alone, the assets and deposits of ILCs increased by $62.7 billion and $38.8 billion, respectively. The number of ILCs chartered in Utah also has nearly doubled since 1997, while the number of ILCs has declined in the few other states permitted to charter exempt ILCs.

The nature and size of individual ILCs and their parent companies also have changed dramatically in recent years. While the largest ILC in 1987 had assets of approximately $410 million, the largest ILC today has more than $60 *billion* in assets and more than $51 *billion* in deposits, placing it among the twenty largest insured banks in the United States in terms of deposits. An additional twelve ILCs each have more than $1 billion in deposits. And, far from being locally owned and focused on small-dollar consumer loans, many ILCs today are controlled by large, internationally active companies and are used to support various aspects of these organizations' complex business plans and operations.

While the growth of ILCs and diversity of ownership in recent years are striking, it also is important to keep in mind that the exception currently is open-ended and subject to very few statutory restrictions. Although only a handful of states have the ability to charter exempt ILCs, there is *no* limit on the number of exempt ILCs that these states may charter, and the FDIC currently has several applications pending to establish new ILCs or to acquire existing ones.

Moreover, federal law places no limit on how large an ILC may become and only one restriction on the types of activities that an ILC may conduct. That restriction prevents most ILCs from accepting demand deposits that the depositor may withdraw by check or similar

means for payment to third parties. This federal restriction has lost much of its meaning as ILCs have entered the world of retail banking by offering retail customers negotiable order of withdrawal (NOW) accounts--transaction accounts that are functionally indistinguishable from demand deposit accounts. Retail and corporate banking activities also are aided by the fact that federal law does not restrict ILCs of any size from collecting FDIC-insured savings or time deposits from institutional or retail customers or from offering the full range of other banking services, including commercial, mortgage, credit card, and consumer loans; cash management services; trust services; and payment-related services, such as Fedwire, automated clearinghouse (ACH) and check-clearing services. Moreover, federal law permits ILCs to branch across state lines to the same extent as other types of insured banks. And, due to advances in telecommunications and information technology, some ILCs now conduct their activities throughout the United States--without physical branches--through the Internet or through arrangements with affiliated or unaffiliated entities.

Public Policy Implications of the Exception

Without action, further expansion of banks operating under this exception threatens to undermine several fundamental policies that Congress has established and reaffirmed governing the structure, supervision and regulation of the financial system. The ILC exception also fosters an unfair and unlevel competitive and regulatory playing field by allowing firms that acquire an insured ILC in a handful of states to operate outside the activity restrictions and consolidated supervisory and regulatory framework that apply to other community-based, regional and diversified organizations that own a similarly situated bank. Addressing these matters will only become more difficult if additional companies are permitted to acquire and operate ILCs under this special exception.

Bank Affiliations with Commercial Entities. For many years, Congress has sought to maintain the general separation of banking and commerce in the United States and has acted affirmatively to close loopholes that create significant breaches in the wall between banking and commerce. For example, one of the primary reasons for enactment of the BHC Act in 1956, and its expansion in 1970 to cover companies that control only a single bank, was to help prevent and restrain combinations of banks and commercial firms under the auspices of a single holding company. And, when the so-called "nonbank bank" loophole threatened to undermine the separation of banking and commerce, Congress acted in 1987 to close that loophole.

In doing so, Congress was motivated by several concerns. One concern was that allowing the mixing of banking and commerce might, in effect, lead to an extension of the federal safety net to commercial affiliates and make insured banks susceptible to the reputational, operational and financial risks of their commercial affiliates. Congress also expressed concern that banks affiliated with commercial firms may be less willing to provide credit to the competitors of their commercial affiliates or may provide credit to their commercial affiliates at preferential rates or on favorable terms. Moreover, Congress expressed concern that allowing banks and commercial firms to affiliate with each other could lead to the concentration of economic power in a few very large conglomerates.[2]

Congress reaffirmed its desire to maintain the general separation of banking and commerce as recently as 1999, when it passed the GLB Act. That act closed the unitary-thrift loophole, which previously allowed commercial firms to acquire a federally insured savings

[2] *See* S. Rep. No. 100-19 (1987); S. Rep. No. 91-1084 (1970); H.R. Rep. No. 84-609 (1955).

association. At the same time and after lengthy debate, Congress decided to allow financial holding companies to engage in *only* those activities determined to be financial in nature or incidental or complementary to financial activities. In fact, in passing the GLB Act, Congress rejected earlier proposals that would have allowed financial holding companies to engage generally in a "basket" of commercial activities or that would have allowed commercial firms to acquire a small bank without becoming subject to the BHC Act.[3]

The ILC exception, however, allows commercial firms to evade these decisions and acquire an FDIC-insured bank with broad deposit-taking and lending powers. It is no coincidence, for example, that commercial firms began to show an increased interest in ILCs only after Congress closed the unitary-thrift loophole in 1999.

The question of whether to allow firms engaged in commercial activities to own or acquire an insured ILC is one that has potentially far-reaching implications for the structure and soundness of the American economy and financial system. We believe it is a decision that should be made deliberately by Congress after hearings, debate, and careful review of the potential benefits and costs to the taxpayer and the economy. This is not a policy that should be established by exploitation of a loophole that was intended for a few small, special purpose entities. This is especially true because pressures likely will build to expand to banking organizations more generally any new policy applied to the owners of ILCs. Once permitted, any general mixing of banking and commerce also is likely to be difficult to disentangle.

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[3] The GLB Act did provide certain nonbanking firms that became a financial holding company after November 1999 up to ten years to *divest* their impermissible commercial holdings if the firm was and remained "predominantly financial." *See* 12 U.S.C. § 1843(n). All commercial investments held under this authority must be divested no later than November 12, 2009.

Once these decisions are made, we see no reason to allow the owners of insured ILCs to make investments and conduct activities denied to owners of similarly situated full-service insured banks.

Bank Affiliations with Financial Firms. Besides restricting the mixing of banking and commerce, Congress also has placed preconditions on the ability of firms that are purely financial to affiliate with banks. The GLB Act allows a bank holding company to engage in a broad range of financial activities, including securities underwriting, various insurance activities and merchant banking, *only* if the holding company keeps all of its subsidiary depository institutions well capitalized and well managed and achieves and maintains at least a satisfactory CRA record at all of the company's subsidiary insured depository institutions. These requirements help ensure that banks operating within a diversified financial company remain financially and managerially strong and help meet the credit needs of their entire communities, including low- and moderate-income families and communities. The ILC exception undermines these requirements by allowing financial firms to own and operate an FDIC-insured bank without abiding by the capital, managerial, and CRA standards established in the GLB Act.

Consolidated Supervision of Domestic and Foreign Banking Organizations. The ILC exception in current law also undermines the supervisory framework that Congress has established for the corporate owners of insured banks, as well as for foreign banks that seek to enter the banking business in the United States. ILCs are regulated and supervised by the FDIC and their chartering state in the same manner as other types of state-chartered, nonmember insured banks and the Board has no concerns about the adequacy of this existing supervisory framework for ILCs themselves. However, due to the special exception in current law, the parent company of an ILC is not considered a bank holding company. This creates special

supervisory risks because the ILC's parent company and nonbank affiliates may not be subject to supervision on a *consolidated* basis by a federal agency.

History demonstrates that financial trouble in one part of a business organization can spread, and spread rapidly, to other parts of the organization. Moreover, as recent events have confirmed, large organizations increasingly operate and manage their businesses on an integrated basis with little regard for the corporate boundaries that typically define the jurisdictions of supervisors. Risks that cross legal entities and that are managed on a consolidated basis cannot be monitored properly through supervision directed at any one, or even several, of the legal entity subdivisions within the overall organization.

It was precisely to deal with these risks to safety and soundness that Congress established a consolidated supervisory framework for bank holding companies that includes the Federal Reserve as supervisor of the parent holding company and its nonbank subsidiaries in addition to having a federal supervisor for the insured depository institution itself. This framework allows the Federal Reserve to understand the financial and managerial strengths and risks within the consolidated organization as a whole and gives the supervisor the statutory authority and ability to identify and resolve significant management, operational, capital or other deficiencies within the overall organization *before* they pose a danger to the organization's subsidiary insured banks. These benefits help explain why many developed countries, including those of the European Union, have adopted consolidated supervision frameworks and why it is becoming the preferred approach to supervision worldwide.

In the United States, the BHC Act has long provided the Federal Reserve broad authority to examine a bank holding company (including a financial holding company) and its nonbank subsidiaries, whether or not the company or nonbank subsidiary engages in transactions, or has

relationships, with a depository institution subsidiary.[4] Pursuant to this authority, the Federal Reserve routinely conducts examinations of all large, complex bank holding companies and maintains inspection teams on-site at the largest bank holding companies on an ongoing basis. These examinations, which are conducted using well-established procedures, manuals and systems, allow the Federal Reserve to review the organization's systems for identifying and managing risk across the organization and its various legal entities and to evaluate the overall financial strength of the organization. By contrast, the primary federal supervisor of a bank, including an ILC, is authorized to examine the parent company and affiliates (other than subsidiaries) of the bank only to the extent necessary to disclose the relationship between the bank and the parent or affiliate and the effect of the relationship on the bank.

Using its authority under federal law, the Federal Reserve also has established consolidated capital requirements for bank holding companies. These capital requirements help ensure that a bank holding company maintains adequate capital to support its group-wide activities, does not become excessively leveraged, and is able to serve as a source of strength, not weakness, for its subsidiary insured banks. The parent companies of exempt ILCs, however, are not subject to the consolidated capital requirements established for bank holding companies and, as the FDIC has noted, may have no expectation that they should serve as a source of strength to their subsidiary ILC. Indeed, among the factors contributing to the failure of a federally insured ILC in 1999 were the unregulated borrowing and weakened capital position of the corporate

[4] In the case of certain functionally regulated subsidiaries of bank holding companies, the BHC Act directs the Board to rely to the fullest extent possible on examinations of the subsidiary conducted by the functional regulator for the subsidiary, and requires the Board to make certain findings before conducting an independent examination of the functionally regulated subsidiary. 12 U.S.C. §1844(c)(2)(B). These limitations also apply to the FDIC and other federal banking agencies in the exercise of their more limited examination authority over the nonbank affiliates of an insured bank, such as an ILC. See 12 U.S.C. § 1831v.

owner of the ILC and the inability of any federal supervisor to ensure that the parent holding company remained financially strong.

Federal law also gives the Federal Reserve broad enforcement authority over bank holding companies and their nonbank subsidiaries. This authority includes the ability to stop or prevent a bank holding company or nonbank subsidiary from engaging in an unsafe or unsound practice in connection with its own business operations, even if those operations are not directly connected with the company's subsidiary banks. On the other hand, the primary federal bank supervisor for an ILC may take enforcement action against the parent company or a nonbank affiliate of an ILC to address an unsafe or unsound practice only if the practice occurs in the conduct of the *ILC's* business. Thus, unsafe and unsound practices that weaken the parent firm of an ILC, such as significant reductions in its capital, increases in its debt or its failure to monitor and address the risks in its nonbanking affiliates, are generally beyond the scope of the enforcement authority of the ILC's primary federal bank supervisor.

Consolidated supervisory authority is especially helpful in understanding and, if appropriate, requiring mitigation of the risks to the federal safety net when a subsidiary bank is closely integrated with, or heavily reliant on, its parent organization. In these situations, the subsidiary bank may have no business independent of the bank's affiliates, and the bank's loans and deposits may be derived or solicited largely through or from affiliates. In addition, the subsidiary bank may be substantially or entirely dependent on the parent or its affiliates for critical services, such as computer support, treasury operations, accounting, personnel, management, and even premises. This appears to be the case at a number of ILCs. For example, the FDIC noted in its recent rulemaking that some of the large corporate owners of ILCs tend to use these banks in ways that involve "unusual, affiliate-dependent" business plans and data

show that seven of the ten largest ILCs each have more than $3 billion in assets but fewer than seventy-five full-time employees.

In addition to constructing a consolidated supervisory framework for domestic banking organizations, Congress has made consolidated supervision a prerequisite for foreign banks seeking to acquire a bank in the United States. Following the collapse of the Bank of Credit and Commerce International (BCCI)--a foreign bank that lacked a single supervisor capable of monitoring its global activities--Congress amended the BHC Act to require that the Board determine that a foreign bank is subject to comprehensive supervision on a consolidated basis in its home country before the foreign bank may acquire a U.S. bank or establish a branch, agency or commercial lending company subsidiary in the United States. The ILC exception, however, allows a foreign bank that is not subject to consolidated supervision in its home country to evade this requirement and acquire an FDIC-insured bank with broad deposit-taking and lending powers.

Fair Competition and Other Issues. The supervisory and regulatory differences that I have just discussed not only have safety and soundness consequences, they also have important competitive and structural consequences. The exception in current law creates an unlevel playing field among organizations that control a bank because it allows the corporate owners of ILCs to operate under a substantially different framework than the owners of other insured banks. These advantages provide incentives for firms to continue to exploit the exception and create the opportunity for firms to engage in "regulatory arbitrage." Over time, such actions could lead to shifts in the structure and supervision of the financial system and the Federal Reserve's ability to prevent or respond quickly to financial crisis.

S. 1356, the Industrial Bank Holding Company Act of 2007

S. 1356, the Industrial Bank Holding Company Act of 2007, as introduced addresses some of the public policy issues raised by the ILC exception. That bill takes the important step of recognizing that the supervisory gaps created by the ILC exception need to be addressed. To do so, the bill would grant the FDIC new supervisory authority for the existing and future corporate owners of ILCs (other than those that are already supervised by a federal banking agency or the Securities and Exchange Commission) that is similar to the authority that the Federal Reserve has with respect to bank holding companies. In addition, the bill would allow a foreign bank to acquire an insured ILC only if the Board (in consultation with the FDIC) determines that the foreign bank is subject to comprehensive, consolidated supervision in its home country under the same standards in the BHC Act that apply to other banking proposals by a foreign bank. The Board supports these efforts to close the domestic and foreign supervisory gaps created by the ILC exception.

On the other hand, the bill would continue to allow new and expansive combinations of banking and commerce. It also would continue to allow firms and foreign banks that engage in broad securities underwriting, insurance and other financial activities to use an ILC to evade the well-capitalized and well-managed requirements and satisfactory CRA standard established under the GLB Act. In this way, the bill would perpetuate competitive imbalances and encourage the continued growth of firms operating under the ILC exception, placing further pressure on the policies established by Congress in these areas for the corporate owners of other insured banks.

With respect to the banking and commerce issue, the bill would allow any firm to acquire or establish an ILC in the future and derive up to 15 percent of its consolidated annual revenues from commercial activities. No similar "basket" is available to the corporate owners of other

full-service insured banks. This 15 percent commercial "basket" also is quite sizable and potentially would allow new firms that acquire an ILC to have significant commercial holdings. For example, several existing firms that engage in financial activities could acquire an ILC and, at the same time, meet the 15 percent test in S. 1356 even if the firm owned a commercial company the size of Kohl's, U.S. Steel, Waste Management, Office Depot, Nike, Hilton Hotels or Southwest Airlines.

The size of this commercial basket also may be affected by the mechanism established in S. 1356 for defining what activities would be considered "commercial" or "financial" for ILC owners. The bill does not define "financial" activities by reference to the GLB Act and, thus, would allow the development of a different definition of "financial" activities than the definition established for financial holding companies in the GLB Act. This potentially would allow the owners of ILCs to engage in activities that would be "financial" under S. 1356, but that would be considered commercial under the GLB Act. In this way, the size of the 15 percent commercial basket may be significantly larger relative to the activities permitted under the BHC Act and create even greater competitive disadvantages for regulated bank holding companies as compared to the owners of ILCs.

Comprehensive Solution

The Board believes the best way to comprehensively address the important current and potential future public policy issues raised by the ILC exception is to close--and not just narrow--the loophole going forward. This approach recognizes the simple fact that ILCs *are* insured banks. Accordingly, it would require any company that acquires an ILC after a specified date to operate subject to the same activity restrictions, regulatory requirements and supervisory framework that apply to the corporate owners of other insured banks. This approach builds on and utilizes the existing regulatory and supervisory framework that Congress has established,

and repeatedly reaffirmed, for the corporate owners of banks and creates a level playing field for all firms that acquire an insured bank in the future.

For reasons of fairness, the Board also supports "grandfathering" the limited number of firms that currently own an ILC and are not otherwise subject to the BHC Act. Such a grandfather provision would allow these firms to continue to engage in activities not permissible for bank holding companies. However, to protect the federal safety net and limit the potential for grandfathered ILCs to operate in ways clearly at odds with the original exception, the Board believes that any grandfathered firm should be subject to consolidated supervision by a federal agency and appropriate restrictions. We would be pleased to work with the Committee and its members in developing the appropriate restrictions that would apply to the limited set of grandfathered firms.

This type of coordinated and comprehensive solution--closing the loophole and "grandfathering" existing owners--is precisely the type of approach that Congress took in 1970, 1987 and 1999 in closing previous exceptions in the banking laws that were undermining the separation of banking and commerce and other important public policy objectives. It also is the right approach to fix the ILC loophole.

Conclusion

Thank you for the opportunity to discuss the Board's views on ILCs. The Board and its staff would be pleased to continue to work with the Committee in developing and improving legislative language that appropriately addresses the core public policy issues raised by the ILC exception.

EMBARGOED UNTIL DELIVERY

STATEMENT OF

JOHN F. BOVENZI
CHIEF OPERATING OFFICER AND DEPUTY TO THE CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

INDUSTRIAL LOAN COMPANIES

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
U.S. SENATE

October 4, 2007
Room 534, Dirksen Senate Office Building

Chairman Dodd, Ranking Member Shelby and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) concerning industrial loan companies and industrial banks (collectively, ILCs).[1]

The FDIC welcomes careful consideration by Congress of the issues regarding commercial ownership of ILCs. These issues are complex and involve key questions of public policy that are most appropriately determined by Congress. This hearing and congressional discussions regarding possible legislative actions are encouraging developments that hopefully will lead to the resolution of key ILC-related issues by the end of the year. Legislative action that clarifies the role and supervision of ILCs would be strongly welcomed and carefully implemented by the FDIC.

In July 2006, the FDIC imposed a six-month moratorium on ILC applications for deposit insurance and notices of change in control. In January 2007, the FDIC Board voted to extend the moratorium for an additional year for those applications for deposit insurance and change in control notices for ILCs that would become subsidiaries of companies engaged in non-financial activities, i.e., commercial activities.[2] This moratorium extension allows the FDIC to carefully weigh the safety and soundness

[1] The terms "industrial loan company" and "industrial bank" mean any insured State bank that is an industrial bank, industrial loan company, or other similar institution that is excluded from the definition of "bank" in the Bank Holding Company Act of 1956 (BHCA) pursuant to section 2(c)(2)(H) of the BHCA, 12 U.S.C. 1841(c)(2)(H).

[2] For purposes of the extended moratorium, the term "financial activity" includes: (i) banking, managing or controlling banks or savings associations; and (ii) any activity permissible for financial holding companies under 12 U.S.C. 1843(k), any specific activity that is listed as permissible for bank holding companies under 12 U.S.C. 1843(c), as well as activities that the Federal Reserve Board (FRB) has permitted for bank holding companies under 12 CFR 225.28 and 225.86, and any activity permissible for all savings and loan holding companies under 12 U.S.C. 1467a(c). The term "non-financial activity" is any other activity. The FDIC has followed the guidance of the FRB and OTS in its interpretations of the term "financial activity" and consulted with the FRB and/or OTS before making any decisions.

concerns that have been raised regarding commercially-owned ILCs. At the same time, the extension of the moratorium provides an opportunity for Congress to consider the important public policy issues regarding the ownership of ILCs by commercial companies.

Although the FDIC is not endorsing any particular legislative proposal, we are committed to providing Congress with any technical assistance necessary to assist passage of legislation that addresses the important issues regarding ILCs. My testimony will briefly discuss the history and characteristics of ILCs, and the FDIC's recent actions relative to ILCs.

Background

In existence since 1910, ILCs are state-chartered insured depository institutions that are supervised by their chartering states and the FDIC. ILCs (also known as industrials, industrial banks, or thrift and loans) historically operated similar to finance companies, providing loans to wage earners who could not otherwise obtain credit. The FDIC has been involved in the supervision of ILCs since 1934 when 29 ILCs received deposit insurance coverage.

ILCs have proven to be a strong, responsible part of our nation's banking system and offered innovative approaches to banking. ILCs have contributed significantly to community reinvestment and development. For example, a non-profit community development corporation operates an ILC designed for the express purpose of serving the credit needs of people in East Los Angeles. Other ILCs serve customers who have not

traditionally been served by other types of financial institutions, such as truckers who need credit to buy fuel far from home. The record to date demonstrates that the overall industry has operated in a safe and sound manner, and that the FDIC has been a vigilant, responsible supervisor of that industry.

The modern evolution of ILCs began in 1982 with the passage of the Garn-St Germain Depository Institutions Act, which expanded ILCs' eligibility to apply for federal deposit insurance. In 1987, the Competitive Equality Banking Act (CEBA) excluded certain ILCs from the definition of "bank" in the Bank Holding Company Act (BHCA). As a result, any company could control an ILC without necessarily being subject to consolidated supervision under the BHCA. In order to be excluded from the BHCA, the ILC must have received a charter from one of the limited number of states issuing them and the law of the chartering state must have required federal deposit insurance as of March 5, 1987. In addition, the ILC must meet one of three conditions:[3] (1) the ILC must not accept demand deposits; (2) its total assets must be less than $100 million; or (3) control of the ILC has not been acquired by any company after August 10, 1987. A company that controls an ILC is not required to be subject to supervision by the Federal Reserve Board (FRB) and, therefore, can engage in commercial activities. While the parent companies of ILCs are not required to be supervised by the FRB or the Office of Thrift Supervision (OTS), several such companies are supervised by these agencies.

Currently, there are 59 insured ILCs, with 46 based in Utah and California. ILCs also operate in Colorado, Hawaii, Minnesota and Nevada. Because the powers of the ILC charter are determined by the laws of the chartering state, the authority granted to an

[3] Bank Holding Company Act section 2(c)(2)(H), 12 U.S.C. 1841(c)(2)(H).

ILC may vary from one state to another and may be different from the authority granted to commercial banks. Over time, some of the chartering states expanded the powers of their ILCs to the extent that some ILCs now generally have the same powers as state commercial banks. Typically, an ILC may engage in all types of consumer and commercial lending activities, and all other activities permissible for insured state banks, except that some states do not permit ILCs to offer demand deposit accounts regardless of institution size.

Profile

ILCs represent a relatively small share of the banking industry. The current portfolio of ILCs accounts for less than one percent of the approximately 8,600 insured depository institutions and approximately 1.8 percent of industry assets. Attachment 1 provides a list of currently insured ILCs with their asset and deposit data as of June 30, 2007.

At year-end 1995, total ILC assets were approximately $12 billion. Beginning in 1996, a number of financial services firms that controlled ILCs began offering their clients the option of holding their uninvested funds in insured deposits in the firms' ILCs through sweep deposit programs. Also in 1996, American Express moved its credit card operations from its Delaware credit card bank to its Utah ILC, causing a substantial increase in ILC assets. As a result of these and other developments, between year-end 1995 and June 30, 2007, total ILC assets grew from approximately $12 billion to $225 billion. More than 60 percent of that growth is attributable to a small number of financial services firms.

Of the 59 existing ILCs, 44 are either widely held or controlled by a parent company whose business is primarily financial in nature. These include ILCs owned by such companies as Merrill Lynch & Co., Inc., American Express Company and Morgan Stanley. These 44 ILCs represent approximately 84 percent of the ILC industry's assets and 87 percent of the ILC industry's deposits as of June 30, 2007. The remaining 15 ILCs are associated with parent companies that may be considered non-financial in nature.

Supervision

ILCs are supervised by the FDIC in the same manner as other state nonmember banks. They are subject to regular examinations, including examinations focusing on safety and soundness, consumer protection, community reinvestment, information technology and trust activities. Four of the largest and most complex ILCs are subject to near continuous on-site supervision. ILCs are subject to FDIC Rules and Regulations, including Part 325, pertaining to capital standards, and Part 364, pertaining to safe and sound standards of operation. In addition, ILCs are subject to restrictions under the Federal Reserve Act governing transactions with affiliates and tying practices, as well as consumer protection regulations and the Community Reinvestment Act. Just as for all other insured banks, ILC management is held accountable for ensuring that all bank operations and business functions are performed in a safe and sound manner and in compliance with federal and state banking laws and regulations.

The primary difference in the supervisory structures of ILCs and other insured depository institutions is the type of authority that can be exerted over a company that

controls the institution. The FRB and the OTS have explicit supervisory authority over bank and thrift holding companies, including some holding companies that currently own ILCs. The FDIC has the authority to examine the affairs of any affiliate of an ILC, including a parent company and any of its subsidiaries, as may be necessary to disclose fully the relationship between the ILC and the affiliate, and the effect of any such relationship on the ILC. However, as a practical matter, where the parent of an ILC is supervised by the FRB or OTS, the FDIC routinely coordinates with these agencies in obtaining such information regarding affiliates. In the case of an affiliate that is regulated by the Securities and Exchange Commission (SEC) or a state insurance commissioner (functional regulators), the FDIC and the functional regulator share information.

FDIC supervisory policies regarding any depository institution, including an ILC, are concerned with organizational relationships, particularly compliance with the rules and regulations intended to prevent potentially abusive practices. The scope and depth of review vary depending upon the nature and extent of intercompany relationships and the degree of risk posed to the depository institution.

The FDIC's overall examination experience with ILCs has been similar to the larger population of insured institutions, and the causes and patterns displayed by problem ILCs have been like those of other institutions. As noted in the Government Accountability Office's 2005 report on ILCs, "from an operations standpoint [ILCs] do not appear to have a greater risk of failure than other types of depository institutions."[4] The authorities available to the FDIC to supervise ILCs have proven to be adequate thus far for the size and types of ILCs that currently exist. However, the number, size and

[4] Government Accountability Office (GAO), Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority, September 2005, p. 24.

types of commercial applicants have changed significantly in recent years, causing the FDIC to carefully examine this new ILC environment.

Recent FDIC Actions Regarding ILCs

Moratorium and Request for Public Comment

On July 28, 2006, the FDIC imposed a six-month moratorium on action with respect to all ILC deposit insurance applications and change in control notices. The purpose of the moratorium was to enable the FDIC to further evaluate: (1) industry developments; (2) the various issues, facts, and arguments raised with respect to the ILC industry; (3) whether there are emerging safety and soundness issues or policy issues involving ILCs or other risks to the insurance fund; and (4) whether statutory, regulatory, or policy changes should be made in the FDIC's oversight of ILCs in order to protect the deposit insurance fund or support important congressional objectives.

Subsequently, on August 23, 2006, the FDIC published in the Federal Register a request for public comment on twelve questions regarding ILCs and their ownership.[5] The FDIC received over 12,600 comment letters in response to the Request for Public Comment during the comment period. Although the vast majority of comments were directed at specific pending applications or notices, a number of comments addressed substantive issues concerning the ILC industry and its regulation.

[5]See Industrial Loan Companies and Industrial Banks, 71 FR 49456 (August 23, 2006).

The FDIC's experience and the comments suggest that no risk or other possible harm is unique to the ILC charter. Rather, concerns about ILCs are focused on their ownership and proposed business models or plans. Consequently, the FDIC's analysis of how to proceed focused primarily on the proposed owners of ILCs. At the time that the initial moratorium expired on January 31, 2007, eight ILC deposit insurance applications and one change in bank control notice were pending before the FDIC.

The Moratorium Extension

Based on the concerns regarding ILC ownership raised during the moratorium period, the FDIC Board extended the moratorium for ILCs that would be owned or controlled, directly or indirectly, by commercial companies. The business plans for these ILCs tend to be more complex and differ substantially from the consumer lending focus of the original ILCs. In many instances, these ILCs directly support one or more affiliate's commercial activities or serve a particular lending, funding or processing function within a larger organizational structure. Consolidated supervision would generally not be present when there is commercial ownership, raising concerns that the supervisory infrastructure may not provide sufficient safeguards to identify and avoid or control safety and soundness risks and the risks to the Deposit Insurance Fund. As a result, the FDIC determined that this class of ownership needs further study and consideration on two key issues: (1) what, if any, increased risks are created by commercial company ownership and (2) how well current supervisory models apply to such owners.

In addition, the FDIC determined that it is appropriate to provide Congress with a reasonable period to consider the developments in the ILC industry and, if necessary, to make revisions to existing statutory authority. Even though the FDIC has authority to act on any particular application, notice, or request involving an ILC, the FDIC considered the potential effect of the extended moratorium on individual applicants and proponents, including commercial companies, and believes that congressional resolution of these issues is preferable.

Consequently, the FDIC concluded that the moratorium should be extended through January 31, 2008 for ILCs that would be owned or controlled, directly or indirectly, by companies engaged in commercial activities. The extension allows the FDIC needed time to evaluate the various issues, facts, and arguments associated with the ownership of an ILC by a commercial company, and allow Congress time to consider legislation concerning ILCs.

Under the extended moratorium, the FDIC has not and will not take action to accept, approve, or deny any application for deposit insurance, or to accept, disapprove, or issue a letter of intent not to disapprove any change in control notice, with respect to any ILC that would become a direct or indirect subsidiary of a company engaged in commercial activities. Although commercially owned ILCs have not resulted in serious problems to date, the FDIC will continue to closely monitor existing ILCs that currently are controlled by commercial companies in light of the concerns that have been expressed.

The moratorium extension does not apply to, and the FDIC is acting on, applications for deposit insurance or change in control notices with respect to: (1) any ILC that would become a subsidiary of a company or companies engaged only in financial activities; and (2) any ILC that would not become a subsidiary of a company.

Since the moratorium was extended, the FDIC's Board has approved four applications for deposit insurance, including applications filed by or on behalf of Capital Source, Marlin Business Services, Security National Master Holding, and WellPoint. The FDIC's Board also voted to issue a non-objection to the proposed investment by Gerald J. Ford and related entities in Fremont General Corporation. In each instance, the FDIC has determined that these entities' activities are financial in nature or are complementary to a financial activity. The FDIC's Board also voted to issue a non-objection to Porsche's proposed increase in its investment in Volkswagen AG. In this case, the FDIC's action was conditioned upon agreements under which the ILC would be divested or liquidated.

Four deposit insurance applications are pending, including filings from or on behalf of DaimlerChrysler, First City Financial, Ceridian, and Security National Financial Corporation. Three notices of change in bank control are also pending, including filings submitted by or on behalf of The Home Depot, the JC Flowers Group,[6] and the Blackstone Group. These entities are seeking to acquire EnerBank, Sallie Mae Bank, and World Financial Capital Bank, respectively.

[6] The JC Flowers Group includes Bank of America and JP Morgan Chase.

Generally, ILCs owned by individuals do not present the same issues as ILCs owned by commercial companies. An ILC owned by individuals is not subject to the BHCA, and has no parent company or subsidiary of a parent company that could present safety and soundness risk or a conflict of interest with the ILC. ILCs that are owned by financial companies that are subject to federal consolidated bank supervision, such as bank holding companies, financial holding companies, and thrift holding companies, generally are subject to the examination, reporting, and monitoring systems of bank supervisors, which can be effective tools in preventing an affiliate's activities from causing a safety and soundness risk to the ILC. Importantly, holding companies that are expected to serve as a source of strength to their subsidiary insured depository institutions provide a resource for an insured bank in need of additional capital.[7] The FDIC believes that these classes of ILC ownership do not need further study and that the supervisory tools currently available to the FDIC are adequate.

Notice of Proposed Rulemaking -- Part 354 of the FDIC's Rules and Regulations

ILCs to be owned by financial companies not subject to federal consolidated bank supervision present some of the same issues as ILCs owned by commercial companies. However, the FDIC has sought comment on whether those issues can be controlled or minimized through existing regulatory authority. Specifically, the FDIC has proposed

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[7] The Gramm-Leach-Bliley Act of 1999 significantly limited the ability of the Federal Reserve Board to impose capital standards on functionally-regulated subsidiaries of a bank holding company. Functionally-regulated subsidiaries generally include any company that is a securities broker/dealer, an investment adviser, an investment company, an insurance company, or an entity subject to supervision by the Commodities Futures Trading Commission (CFTC). See 12 U.S.C. 1844(c). Furthermore, the FRB may not require such a company that is either a bank holding company or an affiliate of the depository institution to provide funds or other assets to the depository institution if the state insurance regulator or the SEC objects. See 12 U.S.C. 1844(g).

additional safeguards that provide adequate protections for the safety and soundness of the insured ILCs and for the protection of the Deposit Insurance Fund.

On February 5, 2007, the FDIC published a Notice of Proposed Rulemaking to enhance its supervisory tools for this class of institutions. While the Notice of Proposed Rulemaking is pending, the FDIC is considering, on a case-by-case basis, deposit insurance applications and change in control notices with respect to ILCs that would become a subsidiary of one or more companies engaged only in financial activities, but which are not subject to federal consolidated bank supervision by the FRB or the OTS.

Among the concerns regarding an ILC being controlled by a company or layers of companies that lack federal consolidated bank supervision are the need for the parent company to serve as a source of capital and liquidity for the subsidiary ILC, the difficulty in identifying problems or risks that may develop in the company or its subsidiaries, and controlling the extent to which these risks affect the ILC. More specifically, concerns have emerged regarding the transparency of parent companies and their subsidiaries, the extent to which a parent company will serve as a source of strength for the ILC subsidiary, and dependence of the ILC on the parent company and its subsidiaries.

The proposed regulation would establish a set of comprehensive safeguards through a set of federal standards and requirements that the FDIC can apply and enforce independent of the state authorities.[8] The proposed rules are intended to provide the safeguards to identify and avoid or control, on a consolidated basis, the safety and soundness risks and the risks to the Deposit Insurance Fund that may result from

[8] While some of the chartering states have supervisory authority over companies that control industrial bank subsidiaries, that is not true of all of the states that charter industrial banks.

ownership by a financial company not subject to consolidated federal bank supervision. The proposed rules will provide enhanced transparency and a system of controls proposed to address the risks presented by such ownership structures.

The conditions and requirements of the proposed regulation are not novel. In many cases financial companies, such as companies engaged in securities or mortgage lending, come under some type of supervision already and, therefore, are accustomed to some form of regulatory structure and supervision. Moreover, some of the requirements that would be imposed by these proposed rules have been imposed in the past on a case-by-case basis. For example, in the course of considering deposit insurance applications or change in control notices, the FDIC has required parent companies to execute written agreements to maintain a subsidiary bank's capital and/or liquidity at certain minimum levels. In addition, the FDIC has required that banks maintain their capital at certain levels and obtain the FDIC's prior consent before making changes to their business plans. Also, the FDIC has imposed conditions aimed at ensuring the independence of the board of directors at subsidiary ILCs.

The FDIC is not proposing any changes in its regulation or supervision of ILCs that will be directly controlled by one or more individuals. Furthermore, the FDIC is not proposing any changes in its regulation or supervision of an ILC that will become a direct or indirect subsidiary of a financial company that is subject to federal consolidated bank supervision (i.e., a bank holding company, a financial holding company, or a thrift holding company).

The proposed rules also will not apply to ILCs that are already owned by financial companies not subject to federal consolidated bank supervision. However, the FDIC will continue to exercise close supervision of these ILCs and any risks that may be created in the future from their parent companies or affiliates to ensure that these institutions continue to operate in a safe and sound manner. In addition, while the proposed rules are pending, the FDIC has been utilizing some or all of the supervisory measures included in the proposed rules in processing deposit insurance applications and change in control notices with respect to ILCs controlled by financial companies not subject to federal consolidated bank supervision.

In publishing the proposed rules, and in extending the moratorium for one year, the FDIC is not expressing any conclusion about the propriety of control of ILCs by commercial companies. Rather, the FDIC has determined that it is appropriate to take a cautious approach designed to provide greater transparency and to limit the potential risks to ILCs and to the Deposit Insurance Fund. The FDIC received 18 comments during the 90-day comment period. We are continuing to evaluate these comments and other relevant information, including any progress on legislation, and are considering options on how to proceed.

Conclusion

The ILC charter has proven to be a strong, responsible part of our nation's banking system. ILCs have offered innovative approaches to banking and have contributed significantly to community reinvestment and development. Yet, the types and number of ILC applications have evolved in recent years and these changes raise

potential risks that deserve further study and important public policy issues that are most appropriately addressed by Congress.

The FDIC has the responsibility to consider applications under existing statutory criteria and make decisions. While it is appropriate to proceed cautiously, the FDIC cannot defer action on these matters indefinitely.

The current statutory exemption providing for the ILC charter is quite broad. By providing clear parameters to the scope of the charter, Congress can eliminate much of the uncertainty and controversy surrounding it. Resolving these issues will enhance the value of the ILC charter going forward. The FDIC looks forward to working with Congress in the coming months as you work to bring these matters to closure.

This concludes my statement. I will be happy to answer any questions that the Committee might have.

Attachment 1

Industrial Loan Companies (Financial Data as of June 30, 2007)

Cert	Insured	Institution	Total Assets	Total Deposits	State	Parent
25158	6/4/1984	FINANCE FACTORS, LTD	661.7	484.7	HI	Finance Enterprises
25653	9/24/1984	FREMONT INVESTMENT & LOAN	10,767.5	9,754.4	CA	Fremont General Corporation
25667	10/5/1984	FIRESIDE BANK	1,437.0	1,210.8	CA	Unitrin, Inc.
25803	12/17/1984	RANCHO SANTA FE TH & L ASSN	100.0	69.2	CA	Semperverde Holding Company
25870	12/17/1984	FINANCE & THRIFT CO	118.5	94.6	CA	F&T Financial Services, Inc.
26271	6/3/1985	HOME BANK OF CALIFORNIA	159.3	104.1	CA	La Jolla Savers and Mortgage Fund
26363	9/10/1985	COMMUNITY COMMERCE BANK	339.9	213.2	CA	TELACU
26615	2/25/1986	GOLDEN SECURITY BANK	138.9	110.4	CA	No affiliation
26704	7/3/1986	BALBOA THRIFT & LOAN ASSN	184.7	166.8	CA	Hafif Bancorporation
26755	8/7/1986	MINNESOTA 1ST CREDIT & SVG INC	26.2	19.2	MN	Minnesota Thrift Company
27330	8/26/1988	SILVERGATE BANK	306.5	184.2	CA	Silvergate Capital
27374	10/31/1988	MERRILL LYNCH BANK USA	60,879.3	51,601.1	UT	Merrill Lynch
27471	3/20/1989	AM EX CENTURION BANK	23,419.5	2,791.5	UT	American Express
27539	6/28/1989	FIRST SECURITY THRIFT CO	152.5	91.3	CA	First American Corp
32707	11/3/1989	CENTENNIAL BANK	673.1	524.8	CA	Land America Financial Group
32743	1/22/1990	CIRCLE BANK	211.6	139.7	CA	New West Bancshares
32992	5/25/1990	MORGAN STANLEY BANK	27,391.0	19,535.0	UT	Morgan Stanley
33493	8/29/1991	TAMALPAIS BANK	520.4	369.9	CA	Epic Bancorporation
33535	12/16/1991	ADVANTA BANK CORP	2,011.4	1,408.2	UT	Advanta
33778	2/12/1993	GE CAPITAL FINANCIAL INC	2,217.3	214.6	UT	GE (General Electric)
34313	8/25/1997	EAGLEMARK SAVINGS BANK	51.6	4.2	NV	Harley-Davidson
34351	9/27/1996	USAA SAVINGS BANK	6,346.3	326.2	NV	USAA Life Company
34404	5/15/1997	WEBBANK	22.5	13.9	UT	Steel Partners II, LP
34519	9/22/1997	MERRICK BANK	1,119.0	880.0	UT	CardWorks, LP
34549	9/22/1997	AMERICAN SAVINGS INC	4.5	2.5	MN	Waseca Bancshares
34599	1/16/1998	PITNEY BOWES BANK INC	664.3	532.2	UT	Pitney Bowes
34697	6/1/1998	WRIGHT EXPRESS FINL SERVICES	1,108.2	927.2	UT	Wright Express
34781	10/1/1998	TRANSPORTATION ALLIANCE BK	507.0	423.7	UT	Flying J, Inc.
34820	4/3/2000	SECURITY SAVINGS BANK	303.8	192.7	NV	Stampede Capital LLC
35141	11/12/1999	BMW BANK OF NORTH AMERICA	2,365.0	1,815.3	UT	BMW Group
35228	11/3/1999	ESCROW BANK USA	33.6	1.0	UT	Capmark Financial Group / GMAC
35260	11/12/1999	REPUBLIC BANK INC	482.4	428.8	UT	No affiliation
35400	1/12/2001	TRUST INDUSTRIAL BANK	2.8	0.6	CO	FISERV
35533	10/5/2000	FIRST ELECTRONIC BANK	14.0	8.1	UT	Fry's Electronics
35575	10/20/2000	CIT BANK	4,065.6	3,078.7	UT	CIT Group
57056	3/1/2001	CELTIC BANK	119.5	97.9	UT	Celtic Investment, Inc.
57225	1/10/2002	VOLKSWAGEN BANK USA	288.0	239.8	UT	Volkswagen
57293	6/3/2002	ENERBANK	150.1	127.1	UT	CMS Energy
57408	7/21/2003	EXANTE BANK	524.8	403.0	UT	UnitedHealth Group
57449	12/22/2003	MEDALLION BANK	323.1	268.0	UT	Medallion Financial
57485	7/6/2004	GOLDMAN SACHS BANK USA	15,028.0	13,341.9	UT	Goldman Sachs
57529	4/1/2003	CAPMARK BANK	6,616.8	4,918.9	UT	Capmark Financial Group / GMAC
57542	8/16/2004	TOYOTA FINANCIAL SAVINGS BANK	272.2	68.6	NV	Toyota
57565	9/15/2003	UBS BANK USA	23,090.8	20,222.2	UT	UBS AG
57570	12/1/2003	WORLD FINANCIAL CAPITAL BANK	177.4	108.4	UT	Alliance Data Systems
57769	9/27/2004	TARGET BANK	15.3	6.5	UT	Target Corporation
57803	8/2/2004	GMAC BANK	23,451.0	10,740.1	UT	Cerberus/GMAC
57833	8/2/2004	BEAL SAVINGS BANK	1,505.8	62.0	NV	Beal Financial Corporation
57962	8/1/2005	ALLEGIANCE DIRECT BANK	45.3	37.3	UT	Leavitt Group Enterprises, Inc.
58009	8/24/2005	LEHMAN BRO. COMMERCIAL BANK	3,431.7	2,849.1	UT	Lehman Brothers Holdings Inc.
58148	1/26/2006	LCA BANK CORPORATION	24.9	18.7	UT	Lease Corporation of America
58160	New	CAPITALSOURCE BANK			UT	CapitalSource, Inc.
58177	11/28/2005	SALLIE MAE BANK	807.3	611.9	UT	Sallie Mae
58267	New	MARLIN BUSINESS BANK			UT	Marlin Business Services, Corp.
58393	5/14/2007	FIFTH STREET BANK	18.7	4.6	NV	Security Natl Master Holding Co
58612	New	ARCUS FINANCIAL BANK			UT	WellPoint, Inc.
90017	7/21/1987	FIRST FINANCIAL BANK	152.5	29.2	CO	First Data Corp.
90040	9/28/1987	HOME LOAN INDUSTRIAL BANK	48.3	39.1	CO	Home Loan Investment Company
91005	11/5/1985	5 STAR BANK	160.6	125.3	CO	Armed Forces Benefit Association
		Totals	225,059.1	152,042.5		

Embargoed until
October 4, 2007, at 10:00 am

Statement of

Scott M. Polakoff, Senior Deputy Director
Office of Thrift Supervision

concerning

Industrial Loan Companies

before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

October 4, 2007

Office of Thrift Supervision
Department of the Treasury

1700 G Street, N.W.
Washington, DC 20552
202-906-6288

Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

Statement on Industrial Loan Companies
before the
Committee on Banking, Housing, and Urban Affairs
United States Senate
October 4, 2007

Scott M. Polakoff, Senior Deputy Director
Office of Thrift Supervision

I. Introduction

Good morning, Mr. Chairman, Ranking Member Shelby, and Members of the Committee. Thank you for the opportunity to address issues related to the activities, ownership and control of industrial loan companies (ILCs). I want to commend you, Mr. Chairman, for holding this hearing. I also want to recognize the efforts of Senators Johnson and Bennett on their past and continuing work on ILC issues, as well as the efforts of Senators Brown, Johnson and Allard on recent ILC legislation.

Today, I will highlight for you the Office of Thrift Supervision's (OTS) views on the supervision and oversight of savings and loan holding companies (SLHCs) that own and/or control ILCs. The OTS currently supervises entities that control over half of ILC industry assets. As of June 30, 2007, there were eight ILCs within OTS-regulated SLHC structures. These eight SLHCs, over which we are the primary federal regulator, include some of the most recognized names in the industry:

- Merrill Lynch & Co.;
- Morgan Stanley;
- American Express Company;
- USAA (United Services Automobile Association);
- Lehman Brothers Holdings, Inc.;
- General Electric Company;
- Beal Financial Corporation; and
- General Motors Corporation.

In other words, the OTS is the primary federal regulator for these SLHCs, whose subsidiary ILCs had aggregate assets of $124 billion or over 55 percent of all ILC assets. In fact, four of the ten largest ILCs are owned or controlled by OTS-regulated SLHC structures. These four ILCs hold aggregate assets of $118 billion, accounting for roughly 59 percent of the assets of the ten largest ILCs.[1] And of the top 15 ILCs,[2] the OTS

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1. The ten largest ILCs held assets of almost $201 billion, accounting for approximately 89 percent of aggregate ILC industry assets.

regulates SLHCs that own or control seven. These seven institutions hold assets of $125 billion, representing 59 percent of the assets of the 15 largest ILCs. The OTS is an active holding company supervisor of all eight SLHCs that currently own an ILC.

ILC legislation raises a number of important issues with respect to the key areas of the permissible activities and oversight of companies that own or control, or seek to acquire or control, an ILC. This includes the continuing role of existing holding company regulators, including the OTS, that oversee and supervise companies that currently own and control ILC industry assets. We believe it is important that any legislation include a forward-looking focus on maintaining the enterprise-wide safety and soundness of holding companies that own or control institutions with access to the federal safety net. This is consistent with the objectives of functional regulation and consolidated regulatory oversight that are important aspects of recent banking legislation.

Understanding the potential exposure of the federal safety net to a company that owns or controls an ILC requires understanding and supervising the interrelationships within the structure and how the ILC is integrated. An effective holding company regulator must oversee the parent holding company of an ILC or other insured depository institution with a keen focus on any affiliate risks, including risks from commercial activities that could impact the insured financial institution. At the OTS, we currently regulate a number of commercial firms that own thrift institutions, and we have a sound and proven oversight program that addresses potential risks arising from commercial activities. In addition to several of the companies I have already highlighted, the commercial entities that we supervise include:

- Temple Inland, Inc. (manufacturing);
- Archer-Daniels-Midland Company (agribusiness);
- John Deer Capital Corporation (manufacturing);
- Nordstrom, Inc. (retail trade);
- Federated Department Stores, Inc. (retail trade);
- HEI Diversified, Inc. (utilities); and
- Hillenbrand Industries, Inc. (manufacturing).

Our SLHC oversight program is supported by our existing authority under the Home Owners' Loan Act (HOLA) that bars loans and extensions of credit by a savings institution to a commercial affiliate while also permitting the flow of credit to customers of a commercial affiliate for legitimate consumer lending activities.

The OTS focuses and tailors its supervision of SLHCs based on the complexity of the structure and the level of risk inherent in the holding company enterprise. Comprehensive supervision of SLHCs is a combination of ongoing on-site examinations, targeted reviews, and off-site monitoring. This combined approach permits the OTS to

2. The 15 largest ILCs held assets of $213 billion, accounting for approximately 94 percent of aggregate ILC industry assets.

maintain an understanding of the enterprise-wide business activities and inherent risks, as well as the affiliations and the transactions of the enterprise.

In order to understand the OTS's perspective on holding company oversight and its role in supervising companies that own or control ILCs, it is necessary to understand the development of the ILC structure, as well as how the OTS evolved as the primary federal regulator of holding companies that control over half of ILC industry assets.

II. Overview on the Development of ILCs and Current Demographics

ILCs have existed since the early 1900s, when a number of small, state-chartered institutions formed to provide a source of unsecured loans to industrial workers who did not have access to financial services at traditional depository institutions. For many years, these small entities remained focused almost entirely, if not exclusively, on serving their existing customer base of industrial workers.

During the last 25 years, however, ILCs have grown considerably in size and number. This growth in assets and aggregate numbers was driven substantially by the eligibility of ILCs for federal deposit insurance in 1982. Also increasing the attractiveness of the ILC charter was legislation in 1987 that exempted companies that own ILCs from the ownership restrictions of the Bank Holding Company Act (BHCA).

Pursuant to these statutory provisions, ILCs are state-licensed, insured depository institutions regulated by their respective state bank supervisors as well as the FDIC under the Federal Deposit Insurance Act (FDIA). These entities are not considered "banks" under the BHCA.[3] As a result, ILCs are currently not subject to holding company

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3. Section 2(c)(2)(H) of the Bank Holding Company Act (12 U.S.C.A. § 1841(c)(2)(H)) provides that the term "bank" does not include "An industrial loan company, industrial bank, or other similar institution which is –

> (i) an institution organized under the laws of the State which, on March 5, 1987, had in effect or had under consideration in such State's legislature a statute which required or would require such institution to obtain insurance under the Federal Deposit Insurance Act [12 U.S.C.A. § 1811 et seq.] --
>
> > (I) which does not accept demand deposits that the depositor may withdraw by check or similar means for payment to third parties;
> >
> > (II) which has total assets of less than $100,000,000; or
> >
> > (III) the control of which is not acquired by any company after August 10, 1987; or
>
> (ii) an institution which does not, directly, indirectly, or through an affiliate, engage in any activity in which it was not lawfully engaged as of March 5, 1987,

except that this subparagraph shall cease to apply to any institution which permits any overdraft (including any intraday overdraft), or which incurs any such overdraft in such institution's account at a Federal Reserve bank, on behalf of an affiliate if such overdraft is not the result of an inadvertent computer or accounting error that is beyond the control of both the institution and the affiliate, or that is otherwise permissible for a bank controlled by a company described in section 1843(f)(1) of this title."

oversight unless the parent company also owns or controls a bank or thrift. Similarly, ILCs are not currently prohibited from commercial affiliations, including being owned or controlled by a commercial company.

Today, although only a handful of states continue to charter ILCs, the charter is active. As of June 2007, there were 59 institutions holding more than $225 billion in aggregate assets. While the five largest institutions dominate the industry, holding $158 billion or roughly 70 percent of aggregate industry assets, 18 of the 59 institutions have assets in excess of $1 billion. As you are aware, interest in the ILC charter remains strong.

An issue that has generated some attention in the ILC debate is the role of a holding company regulator. Currently, there is a lack of clear statutory authority for a federal regulator of an ILC holding company that does not otherwise own a bank or thrift. It is important to address this issue while also recognizing the strength of the existing regulatory framework, which allows both the FRB and OTS to fulfill their statutory roles as holding company regulators.

III. OTS Authority and Supervision of SLHCs

The population of holding companies regulated by the OTS ranges from non-complex companies with limited activities to large, internationally active conglomerates that engage in numerous, diverse activities and an array of domestic and international transactions. In connection with our oversight and supervision of SLHCs and their subsidiary savings institutions, we have a well-established supervisory program for discharging the responsibilities assigned to us by law. Holding company supervision is an integral part of this oversight program and enables us to ensure risk-focused oversight of the entities that own or control licensed thrift institutions.

The OTS holding company oversight program appropriately balances the need for effective supervision with the interests of a holding company enterprise to avoid excessive regulatory intrusion in its affairs. We focus on the company's capital and earnings, risk management framework, and governance structure. We evaluate the oversight provided by the board of directors, and the effectiveness of holding company management at all levels. We also continually review key risk control functions, such as the enterprise's risk management framework, the internal audit function and the major risk concentrations and transactions that occur within the consolidated entity.

Our program is designed to focus on how the company conducts business and manages risk throughout the enterprise. This approach allows us to accurately assess the financial condition and risk profile of the holding company enterprise. It also enables us to consider the impact of the enterprise on insured depository subsidiaries or other regulated financial companies within the structure. The program is designed to provide constructive and substantive feedback on these critical issues to boards of directors and management.

As noted above, OTS authority as the primary supervisor of consolidated SLHCs is set forth in the HOLA. Pursuant to this authority, any company that proposes to acquire a thrift, and thereby become a SLHC, is subject to a statutory licensing (authorization) process that requires us to make numerous statutory findings.

In addition, the OTS has full legal, examination, and enforcement powers over savings associations, SLHCs (including SLHC affiliates and subsidiaries), thrift subsidiaries, and third-party contractors performing services for, or conducting activities on behalf of, any of these entities. In particular, the HOLA provides that SLHCs and each subsidiary thereof (other than a bank) are subject to OTS examination.[4] This authority includes the ability to examine and oversee any activity or entity in a SLHC structure, as well as to take enforcement action when appropriate.

In exercising its statutory oversight authority, the OTS works cooperatively with other sectoral and functional regulators, including federal and state banking agencies, as well as state insurance and federal securities supervisors. We also coordinate with various international financial supervisors on the supervision and oversight of internationally active SLHCs and their affiliates and subsidiaries. Pursuant to our extensive communication and coordination with other supervisory agencies, we have information sharing, coordination, and confidentiality agreements with more than 60 domestic and international supervisors.

In addition, our supervisory program is internationally recognized by foreign regulators, including the United Kingdom's Financial Services Authority (FSA) and France's Commission Bancaire, and has achieved equivalency status from the European Union for three firms – General Electric Company, AIG (American International Group), and Ameriprise Financial Group. We are also recognized by statute as one of two U.S. regulators (along with the FRB) authorized to make a determination as to whether a foreign bank entering the U.S. is subject to comprehensive consolidated supervision for purposes of coordinating consolidated oversight of its domestic banking activities. The OTS's status as a consolidated U.S. supervisor necessitates extensive contact with the domestic and international supervisory community for these and other internationally active complex firms supervised by the OTS.

In carrying out our statutory holding company authority, we conduct an extensive supervisory program. SLHCs are subject to reporting and examination requirements defined by the OTS. In this regard, we tailor information requests and examinations to address the specific issues and risks at an institution and/or a SLHC. Examiners conduct holding company examinations concurrently with the statutorily mandated schedule for annual (or 18-month) examinations of thrifts.

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4. The Gramm-Leach-Bliley Act imposed certain limitations on the OTS's ability to examine functionally regulated subsidiaries.

We also follow a continuous supervision program at the largest and most complex thrifts and SLHCs. This program includes developing a risk assessment, a supervisory plan, and conducting targeted reviews of high-risk areas. We coordinate with functional regulators and routinely meet with senior management and the boards of directors of a thrift or SLHC and its subsidiary organizations.

The OTS follows a risk-focused, top-down examination approach at all SLHCs. We analyze the parent holding company and material subsidiaries for their impact on the SLHC structure. There is particular scrutiny on the extent of any direct and/or indirect adverse finding that may affect the subsidiary thrift institution. This includes a review of intra-group transactions and risk concentrations in order to assess material transactions between affiliated entities. We also determine which business lines present the greatest potential risks to a SLHC, on a consolidated basis, and its subsidiary savings association.

OTS examination procedures are centered on an enterprise-wide assessment of the Capital, Organizational Structure, Risk Management,[5] and Earnings/Liquidity of a holding company structure. This "CORE" examination approach is designed for understanding, analyzing, and evaluating a firm's risk appetite and its approach to risk management. The more complex the firm, the more comprehensive our review and assessment of its risk profile and the effectiveness of its risk control functions.

The OTS works to reduce regulatory burden and redundant supervision by working cooperatively with other functional supervisors. For example, we obtain copies of examination reports for material subsidiaries. Other examples of our coordination with other supervisors include:

- Hosting annual supervisors' meetings on financial conglomerates for all supervisors with material business subsidiaries in the conglomerate to discuss common trends, findings, or violations.
- Routine communications with the FDIC and state bank supervisors regarding ILCs within SLHC structures. We rely on the expertise and examinations of these functional regulators, rather than conducting our own examination of each material entity. If there is a material problem within an ILC that affects the holding company enterprise, we work closely with the functional regulator to minimize the impact on the enterprise and/or the OTS-regulated thrift.
- Cooperating extensively with the FDIC and the State of Utah on several information technology examinations of SLHCs with ILC subsidiaries. In

5. Pursuant to guidance published for comment on April 9, 2007, the OTS is in the process of implementing a revised SLHC ratings and examination focus that substitutes Risk Management for the current Relationship component. This revision is consistent with the existing risk management focus of the OTS CORE ratings system for evaluating enterprise-wide risk assessment in OTS-supervised SLHCs.

these exams, each regulator appointed a central point of contact for each firm, with quarterly meetings to discuss examination strategy and planning.

- Requesting copies for review of SEC filings, audit reports, rating agency reports, and internal management reports (all of which generally include analysis of the ILC subsidiary if it is a material portion of the enterprise).
- Obtaining the most recent examination reports for an ILC when the OTS conducts a holding company examination. When the ILC reports indicate a significant weakness or concern, we follow up with the primary regulator. If the examination reports do not reveal any concerns, we incorporate the review and findings as part of our risk-focused examination approach.

Finally, the Government Accountability Office (GAO) confirms that the OTS has a strong and internationally recognized consolidated holding company supervision regime. We have worked hard in recent years to ensure that this program is up to the task of supervising the complex and internationally active SLHCs subject to our oversight.

Among the factors stressed by the GAO with respect to consolidated supervisory oversight is the importance of interagency collaboration. As noted above, this is an area in which the OTS is particularly aggressive, with outreach to both domestic and international supervisors to ensure the agency can incorporate the views of all functional regulators into its examination reports.

The OTS's consolidated holding company oversight program is a viable model for SLHCs with diverse and wide-ranging activities and operations. It is particularly effective in accommodating the various and sometimes competing interests within holding companies that own or control other companies engaged in functionally regulated activities and that own or control an insured depository institution, including an ILC.

IV. Conclusion

The OTS has extensive experience overseeing SLHCs, including financial conglomerates and commercial holding company structures. The agency evaluates the consolidated holding company structure as well as the relationship between the insured depository institution and its affiliates. OTS supervision provides a strong and robust regulatory framework that oversees a SLHC's risk management platform, rather than dictating the course of conduct of the affairs and operations of the holding company. This approach ensures the flexibility these firms require to compete in a dynamic marketplace while providing a strong supervisory structure over their policies, procedures and activities.

We support Committee efforts to address concerns with respect to the oversight of ILC holding company parents, recognizing that OTS currently exercises effective supervision of SLHCs that control more than half of ILC industry assets nationwide. In considering ILC legislation, we urge the Committee to preserve existing OTS authority

and oversight of SLHCs that own or control ILCs. This will promote functional regulation while also promoting consolidated regulatory oversight of these holding companies. Thank you.

TESTIMONY OF

ERIK SIRRI, DIRECTOR
DIVISION OF MARKET REGULATION
U.S. SECURITIES AND EXCHANGE COMMISSION

THE CONSOLIDATED SUPERVISION OF U.S. SECURITIES FIRMS AND AFFILIATED INDUSTRIAL LOAN CORPORATIONS

BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

OCTOBER 4, 2007

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Testimony Concerning the Consolidated Supervision of U.S. Securities Firms and Affiliated Industrial Loan Corporations

Erik Sirri
Director, Division of Market Regulation
U.S. Securities & Exchange Commission

Before the Committee on Banking, Housing, and Urban Affairs

United States Senate

October 4, 2007

Chairman Dodd, Ranking Member Shelby and Members of the Committee:

I am very pleased to have the opportunity this morning to describe the Securities and Exchange Commission's program for supervising U.S. securities firms on a consolidated basis. I look forward to explaining how this system of supervision provides protection to all regulated entities in the consolidated group, including the Industrial Loan Companies that are the topic of this morning's hearing. Recent events in the credit markets have emphasized the importance of having a robust regime for supervision of financial institutions.

The Commission currently supervises five of the major U. S. securities firms on a consolidated, or group-wide, basis: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley. For such firms, referred to as consolidated supervised entities or "CSEs", the Commission oversees not only the US registered broker-dealer, but also the holding company and all affiliates on a consolidated basis. These affiliates also include other regulated entities, such as foreign-registered broker-dealers and banks, as well as unregulated entities such as derivatives dealers. Four of the firms, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley own ILCs that account for 1.0%, 0.6%, 7.2% and 1.2% of consolidated assets, respectively. Three of the firms, Lehman Brothers, Merrill Lynch and Morgan Stanley also own thrifts that account for 3.3%, 1.7% and 0% of the consolidated assets of each firm respectively.

The CSE program provides consolidated supervision to investment bank holding companies that is designed to be broadly consistent with Federal Reserve oversight of bank holding companies. This prudential regime is crafted to allow the Commission to monitor for, and act quickly in response to, financial or operational weakness in a CSE holding company or its unregulated affiliates that might place regulated entities, including US and foreign-registered banks and broker-dealers, or the broader financial system at risk. When a CSE firm has a regulated entity in the consolidated group that is subject to oversight by another functional regulator, the Commission defers to that functional regulator as the supervisor of the regulated affiliate. We also share relevant information concerning the holding company with our fellow regulators, both domestically and internationally. Indeed the Commission's CSE program has been

recognized as "equivalent" to that of other internationally recognized supervisors, including the U. S. Federal Reserve, for purposes of the European Union's Financial Conglomerates Directive.

While maintaining broad consistency with Federal Reserve holding company oversight, the CSE program is tailored to reflect two fundamental differences between investment bank and commercial bank holding companies. First, the CSE regime reflects the reliance of securities firms on mark-to-market accounting as a critical risk and governance control. Second, the design of the CSE regime reflects the critical importance of maintaining adequate liquidity in all market environments for holding companies that do not have access to an external liquidity provider.

Before I describe the CSE program in detail, I will provide some historical perspective. Over the past twenty years, the Commission, in its role as the functional regulator of US broker-dealers, became increasingly concerned about the risk that a broker-dealer may fail due to the insolvency of its holding company or an affiliate. This risk, as broker-dealers have become affiliated with more and more complex holding company structures, was exemplified by the bankruptcy of the Drexel Burnham Lambert Group and the consequent liquidation of its broker-dealer affiliate in 1990. Post-Drexel, the Commission and its staff undertook a number of initiatives to conduct group-wide risk assessments of financial institutions with significant broker-dealer subsidiaries. The initiatives included (1) Commission risk assessment rulemaking using authority granted by the Market Reform Act of 1990 requiring larger broker-dealers to provide certain information about material affiliates, (2) creation of the Derivatives Policy Group consisting of firms active in OTC derivatives that agreed to voluntarily provide information to Commission staff about their OTC derivatives activities, and (3) the Commission's program for supervision of broker-dealers that register as OTC derivatives dealers. These initiatives assisted the Commission in understanding how financial institutions with large broker-dealer subsidiaries manage risk globally at the group-wide level, and have over time allowed the Commission to develop a unique capacity to regulate securities firms.

Motivated in part by the need for group-wide risk monitoring, and in part by requirements of the European Union's Financial Conglomerates Directive, which essentially requires non-EU financial institutions doing business in Europe to be supervised on a consolidated basis, the Commission in 2004 crafted a new comprehensive consolidated supervision regime that was intended to protect all regulated entities within a group including broker-dealers. The rule was designed to restrict eligibility to those groups with a large and well-capitalized broker-dealer. In other words, the Commission believed that it should only supervise on a consolidated basis those firms engaged primarily in the securities business, and not holding companies affiliated with a broker-dealer incidental to its primary business activity. As a result, the rule effectively requires that the principal broker-dealer have tentative net capital, measured as equity plus subordinated debt less illiquid assets, of at least $5 billion.

The CSE program has five principal components: First, CSE holding companies are required to maintain and document a system of internal controls that must be

approved by the Commission at the time of initial application. Second, before approval and on an ongoing basis, the Commission examines the implementation of these controls. Third, CSEs are also monitored continuously for financial and operational weakness that might place regulated entities within the group or the broader financial system at risk. Fourth, CSEs are required to compute a capital adequacy measure at the holding company that is consistent with the Basel Standard. Finally, CSEs are required to maintain significant pools of liquidity at the holding company, where these are available for use in any regulated or unregulated entity within the group without regulatory restriction.

Before I expand on each of these in turn, I would like to point out that these five principal program components are implemented in conjunction with the authority to protect regulated entities within the groups. When potential weaknesses are identified, the Commission has broad discretion under our rules to respond, for example by mandating changes to a firm's risk management policies and procedures, by effectively requiring an increase in the amount of regulatory capital maintained at the holding company, or by requiring an expansion of the pool of highly liquid assets held at the parent. These powers are not theoretical abstractions. All three of the steps that I just cited, namely requiring changes to risk management systems, requiring more capital, and requiring more liquidity have been taken at various firms over the past two years.

1. The requirement to maintain and document a system of risk controls, including measures to manage the market, credit, liquidity, legal, and operational risks associated with a CSEs business activities, is vested in Exchange Act Rule 15c3-4, by which CSEs must abide. Review by the staff, and ultimate approval by the Commission, of this system of risk controls is a critical part of the process by which each of the five investment hank holding companies became a CSE. While in many respects the system of controls present at the CSE firm bears a strong similarity to analogous systems at other large, complex and internationally active financial institutions, they do reflect the importance to securities firms of daily mark-to-market of most positions as a risk management and risk governance tool. Establishing effective controls around the mark process, particularly where less liquid or more complex products are concerned, is a major focus both of the firm's risk management and financial control functions, and of the Commission's supervision program.

2. Subsequent to approval, the Commission conducts periodic examinations of the CSE's risk and financial controls. These examinations are intended to test whether the documented policies and procedures, particularly concerning the marking of positions to market, are implemented in a consistent and robust fashion. Examinations are focused on the holding company and its unregulated affiliates. Banking affiliates, including ILCs, already subject to supervision by a federal financial regulator are not subject to Commission examination.

3. The CSE supervisory regime is designed to leverage the work of the control functions within the firms. To monitor the financial and operational condition of the holding company, and to verify that the risk control system is functioning effectively, a multi-disciplinary team of Commission staff, including economists, financial engineers,

and accountants, meet regularly with senior risk managers, financial controllers, treasury personnel, and internal auditors of the CSEs. A key theme throughout these discussions is risk concentration, and how the control functions collectively manage concentrated exposures of various types.

Commission staff meets monthly with senior market and credit risk managers of the CSEs charged with managing a bidirectional flow of risk information between the trading businesses which take market and credit risk, and the senior management. In one direction, value-at-risk and other techniques are used to aggregate exposures across diverse businesses with different underlying risk factors both for internal risk management and regulatory capital computations. In the other direction, a granular system of limits articulates to each business or desk the risk appetite of senior management. During the monthly meetings, the performance of the models and aggregation tools are assessed, by comparing ex ante measures of risk with ex post realizations of gain and loss. The monthly discussion is structured around a review of risk reporting and analytics prepared for the internal use of the firm's management.

On a quarterly basis, Commission staff meets with CSE treasury personnel at each firm. The focus of the discussion is the liquidity position of the holding company and, in particular, the amount and nature of liquid assets that are held at the parent, and thus available for use anywhere within the group. Of equal importance, however, are the less liquid assets held by the firm. The CSE firms use a liquidity scenario, approved by the Commission, which is intended to capture the effects of a prolonged market stress event to calibrate liquidity requirements, which includes retirement of outstanding short-term debt and additional funding requirements reflecting a presumed deterioration in the ability to fund less liquid assets through repo and repo-like transactions. During the quarterly discussion, material changes in the liquidity requirements generated by this analysis are discussed.

Quarterly meetings are also held with the CSE financial controllers to review the financial results including significant profit or losses at the desk level. Financial results are also compared with the risk exposures theoretically associated with those gains or losses as a means of validating that the risk measurement systems are functioning properly. The results of the firm's internal price testing processes, intended to validate the marking-to-market of complex and illiquid products, are also reviewed.

Also on a quarterly basis, Commission staff meets with CSE internal auditors to cover significant audit findings and the evolution of the audit plan throughout the year. The resolution of findings, or their escalation to the firm's audit committee, is tracked. Selected audit reports, particularly those related to risk governance, are discussed in detail with the audit staff.

4. The on-site work described above is augmented by the Commission staff's review of monthly holding company capital adequacy measures, which are required under the CSE rule to be computed in a manner consistent with the Basel Standard. While not required by the rule, all of the firms are applying Basel II and its advanced approach to credit risk exposure. Each CSE has undertaken to maintain a ratio of regulatory capital

to risk-weighted assets of at least 10 percent, the Federal Reserve's standard for a well-capitalized institution.

5. The final component of the program is a liquidity pool that each CSE is required to maintain at the parent level. In addition to the Basel capital calculation required of CSE firms, the Commission also requires CSE firms to meet certain liquidity standards. Securities firms rely on a wide range of funding sources, notably repo and repo-like secured financing of assets. In the face of any crisis - whether real or only perceived - secured lenders are likely to require significantly more collateral while unsecured lenders may disappear altogether. CSE firms must conscientiously manage this liquidity risk using their own resources. There are a number of instances where securities firms that were adequately capitalized by the measures of the day collapsed because the asset side of the balance sheet proved insufficiently liquid to withstand a stress event. Thus, under the CSE program, the Commission looks not just at capital adequacy, but also at the liquidity of the assets being supported by that capital through an additional set of standards. Generally, each CSE firm must have sufficient stand-alone liquidity and sufficient financial resources to meet its expected cash outflows in a stressed liquidity environment for a period of at least one year. To meet these standards, each CSE firm holds a substantial amount of liquid assets that are available to the ultimate holding company and its subsidiaries to deal with a crisis or perceived crises anywhere within the organization. Again consistent with the Commission's authority under the rule, each CSE has undertaken to maintain a liquidity pool of specified size.

I have described this morning a system of consolidated supervision that has thus far demonstrated its effectiveness during the current credit market difficulties. It appears to be effectively achieving the goal of reducing the likelihood that weakness within the holding company or an unregulated affiliate will place a regulated entity, including an ILC, or the broader financial system, at risk. I have described the means by which we monitor on an ongoing basis the financial and operational condition of the CSE holding companies, leveraging our many years of experience in overseeing broker-dealers and their affiliated holding companies. And I have described our broad authority under the CSE rules to take action in the event of a weakness or potential weakness. Further, while the program is similar to other consolidated supervision regimes, notably the Federal Reserve's oversight of Bank Holding Companies, the CSE regime is tailored to reflect the reliance of securities firms on mark-to-market accounting as a critical risk and governance control, as well as the need for such firms to maintain adequate internal liquidity sources to withstand market stress events. The CSE program is recognized internationally as providing consolidated supervisory oversight of our largest U.S. securities firms that is equivalent to that of well recognized federal banking regulators. And finally, we are constantly learning from our experience in supervising these firms and we are continually evaluating the CSE regime for any potential improvements.

In conclusion, while we generally support the goals of consolidated supervision of holding companies affiliated with industrial loan companies, any legislation should ensure that CSEs, which are highly regulated under the Commission's consolidated supervision program, are not subjected to an additional layer of duplicative and burdensome holding company oversight. Any legislation should recognize the unique

ability of the Commission to comprehensively supervise the consolidated groups that are overwhelmingly in the securities business, especially given the heightened focus on these issues in an era of increased global competitiveness. And any legislation should respect the careful deference accorded by the Gramm-Leach-Bliley Act to functional regulators in overseeing the activities of functionally regulated members of financial holding companies.

Thank you again for the opportunity to speak on behalf of the Commission. I would be happy to answer any questions that you may have.

10-3-07

TESTIMONY OF

G. EDWARD LEARY

COMMISSIONER OF FINANCIAL INSTITUTIONS

STATE OF UTAH

BEFORE THE

BANKING, HOUSING AND URBAN AFFAIRS

COMMITTEE

U.S. SENATE

OCTOBER 4, 2007

Good morning, Chairman Dodd, Ranking Member Shelby and members of the committee, thank you for the opportunity to share Utah's view on the regulation and supervision of industrial banks or as they are sometimes called Industrial Loan Companies.

I am Edward Leary, Commissioner of Financial Institutions for the State of Utah. I have been involved with banking for thirty-three years, first as a community banker, then fifteen years in bank examiner positions with the Utah Department and for the last fifteen years as its Commissioner. I am pleased to be here today to share my views on the supervision and regulation of industrial banks.

STATE CHARTER OPTION

As we all know, banking is integral to the fabric of economic life for all of us. Since the founding of this nation, states have chartered, regulated and supervised banking. The choice of charter remains a vital component of the check and balances of the dual banking system. State-chartered institutions in attempting to survive and meet the needs of their communities have fostered creativity and experimentation. The state-chartered institutions can innovate in a controlled environment that limits systemic risks. If a product, service, delivery mechanism or charter is fundamentally unsafe or unsound then those weaknesses may be exposed.

Today largely as a result of federal preemption the states are losing assets and state-chartered depository institutions are becoming a less viable and appealing charter.

The following numbers illustrate the dramatic shift in percentage of assets by chartering agency.

Date	States	OCC	OTS
12/31/1995	41%	45%	14%
12/31/2000	42%	46%	12%
12/31/2001	41%	46%	12%
12/31/2002	42%	46%	12%
12/31/2003	41%	47%	12%
12/31/2004	31%	55%	13%
12/312005	31%	55%	14%
12/31/2006	30%	57%	12%

Another foundation of the dual banking system is the ability to freely choose the supervisory structure under which the insured entity operates. This foundation contributes to a competition in excellence among financial institution regulators. It is therefore vital that there is more than one approach to the regulation and supervision of financial institutions.

In today's environment of decreasing assets in state-chartered institutions, industrial banks are experiencing asset growth. Why? Because of the innovations in customer service and delivery of financial products to targeted segments that consumers have responded to very well. Based upon Utah's history and experience in chartering and regulating industrial banks, my view and statement is that industrial banks are the embodiment of what is right and proper in the dual banking system.

The irony is that while many profess belief in the Dual Banking System and are staunch supporters of its merits in providing safe, sound banks with competitively priced financial services and products to consumers and businesses; today we are discussing restrictions and limitations on a state-chartered, federally insured banking industry that I believe embodies real innovation and creativity in the delivery of banking services.

A statement from the former Federal Reserve Chairman, Alan Greenspan, is an appropriate ending to this section.

"A system in which banks have choices, and in regulations that result from the give and take involving more than one agency, stands a better chance of avoiding the extremes of Supervision." (No Single Regulator for Banks, Wall Street Journal, December 15, 1993.)

WHAT THE PUBLIC POLICY DEBATE *SHOULD* BE

The fact that the committee is having this hearing today reflects the reality that Utah's chartering and regulating of the industrial banks has been commensurate to the risk. Utah, in partnership with the FDIC, has jointly created a supervisory model for industrial banks that has evolved and will likely continue to evolve, but through more than twenty years of everyday application, it has worked, in that no Utah industrial bank has failed.

My belief is that this committee should not consider rewriting banking laws to address the desires of particular industry groups or trade associations whose desire is to suppress competition.

Nor should Congress change, much less outlaw a proven, successful regulatory structure because some groups have concerns about a particular applicant.

Testifying before Congress on financial services reform in 1987, the FDIC's then-chairman L. William Seidman argued that the public interest would be best served by:

> *"... financial services industry that met four objectives: the financial system should be viable and competitive, the banking system should be operated in a safe and sound manner, customers should realize benefits from enhanced competition, and the system should be flexible enough to respond to technological change. Consistent with these objectives, the regulatory and supervisory structure of banking should be the simplest and least costly one available."*

The question facing policy makers then was - and continues to be - whether these objectives can be met without restricting the ability of banks to choose the corporate structure that best suits their business needs. As Seidman noted:

> *"The pivotal question . . . is: Can a bank be insulated from those who might misuse or abuse it? Is it possible to create a supervisory wall around banks that insulates them and makes them safe and sound, even from their owners, affiliates and subsidiaries? If so, then the banking and commerce debate should focus on how affiliations should be regulated so that the public interest is met." (FDIC Banking Review, January 2005, The Future of Banking in America, The Mixing of Banking and Commerce: Current Policy Issues, Volume 16, No. 3.)*

I urge this committee and Congress to focus on the adequacy of the current regulatory processes conducted by the State of Utah and the FDIC. In the absence of a demonstrated example of regulatory failure, there is no fundamental, underlying reason for a public policy change.

If, in the future, shortcomings are identified, an amendment may be considered without outlawing a class of banks that have operated for over a century without harming competitors, consumers or the deposit insurance system. Believe me, if I am still the Commissioner when a shortcoming in our regulatory process is identified, it will be corrected, long before any legislative body could take action. The states and the FDIC have developed prudential standards that are in place today.

UTAH INDUSTRIAL BANKS

As of June 30, 2007, all of the nation's 59 operating industrial banks represented a very small .7% component of the 8,615 total insured banks and savings banks. Nationally, industrial banks also represented a very small $226 billion of the $12.2 trillion of the insured bank and savings bank total assets, or 1.8%.

Looking specifically at Utah industrial banks for the period ending June 30, 2007, Utah had 31 operating charters holding $200.9 billion in total assets.(See Appendix -1) Thus, Utah holds 89% of all industrial bank assets. Utah industrial banks represent only 1.6 % of the insured bank and savings bank total assets, and 1.7% of total deposits with $138 billion of the $8.0 trillion in total insured bank and savings bank deposits. Currently, there are 30 operating industrial bank charters as MagnetBank converted to a commercial bank charter in August. The foregoing percentages were determined by the Utah Department of Financial Institutions based upon numbers derived from the FDIC database as of June 30, 2007.

A statement has been made that there has been a *"stampede"* to the industrial bank charter. An analysis of the number of charters over the last twenty years will show that there has been on average an increase of one charter per year. (See Appendix - 2)

As of June 30, 2007, the Utah Department's, non-determinative and non-binding analysis using the provisions of the House passed H. R. 698 is listed in Appendix - 3. The Utah Department's analysis based upon knowledge of the industrial bank holding companies is that 82% of Utah's industrial bank assets would be considered held by *"financial"* entities.

As of June 30, 2007, the Utah Department's, non-determinative and non-binding analysis using the provisions of the House passed H. R. 698 is listed in Appendix - 4. The Utah Department's analysis based upon knowledge of the industrial bank holding company is that 18% of Utah's industrial bank assets would be considered held by *"non-financial"* entities.

The increase in Utah industrial bank *"non-financial"* assets over the last six months is largely attributable to Utah and FDIC's approval of the General Motors application to sell a 51% interest in GMAC. GMAC held a Utah industrial bank, the GMAC Automotive Bank. The FDIC granted an exception to its six-month moratorium on industrial bank applications and approved the sale and subsequent merger, which resulted in $23.5 billion in additional mortgage assets coming to the Utah industrial bank. The renamed GMAC Bank is considered a *"non-financial"* Utah industrial bank.

The Utah Department's analysis of those Utah industrial banks with a Federal Agency supervising the holding company is listed in Appendix - 5. The Utah Department's analysis is that seven entities holding 77% of all Utah industrial bank assets are currently subject to a Federal Holding Company Supervisor at the holding company level.

UTAH'S REGULATORY STRUCTURE & EXPERIENCE IN PARTNERSHIP WITH THE FDIC

Utah has been chartering industrial banks since the 1920s. In 1986, Utah law was changed to require Federal Deposit Insurance for all industrial banks.

Like most state banking departments, Utah regulates all types of state-chartered depository institutions, including banks, industrial banks and credit unions. The Utah department also has jurisdiction over many non-depository activities. The Utah department is entirely funded from assessments to the financial institutions we regulate through a restricted account that can only be appropriated to the department.

As state-chartered, FDIC insured institutions, industrial banks are currently operating in the states of Utah, California, Colorado, Hawaii, Indiana, Nevada and Minnesota. No state permits industrial banks to engage in activities that are not permissible for other state-chartered banks.

Industrial banks are subject to the same banking laws and are regulated in the same manner as other depository institutions. They are supervised and examined both by the states that charter them and by the FDIC. They are subject to the same safety and

soundness, consumer protection, deposit insurance, Community Reinvestment Act, and other requirements as other FDIC-insured banks. However, special emphasis is placed on Federal Reserve Regulation W and Sections 23 A & B of the Federal Reserve Act, which closely regulates all parent and affiliate company transactions to ensure that there is a limit to the amount of *"covered transactions"* and an *"arms length"* basis for all transactions.

A Utah industrial bank is required to maintain the minimum amount of capital required by its federal deposit insurer, but the Commissioner may require a greater amount of capital.

The department has and will continue to defend our regulation and supervision of the industrial bank industry. The department takes its supervisory role seriously. It is an active participant with the FDIC in all industrial bank examinations and targeted reviews wherever they are conducted in the country. Our examiners are participating in large loan exams (reviewing loans and lines-of credit in the $100's of millions), capital market examinations, trust exams, information system exams, consumer compliance and community reinvestment exams and bank secrecy act and anti-money laundering exams.

Utah believes it is a full partner in regulating, supervising and examining this industry. As proof of that fact, Utah is one of the very few states in the country performing CRA/Compliance examinations. Utah conducts most of these examinations jointly with the FDIC. To solidify this relationship with the FDIC, Utah signed a written agreement in January of 2004.

Utah is participating with the FDIC in the Large Bank Supervision Program for four industrial banks: Merrill Lynch Bank USA, UBS Bank USA, American Express Centurion Bank and Morgan Stanley Bank. The supervision of these large banks is coordinated by a full-time relationship manager from the State as well as the FDIC.

A team of examiners and specialists from Utah and the FDIC conduct targeted reviews in areas such as: commercial and retail credit, capital markets, bank technology, asset management, and compliance and they track the quality and quantity of risk management procedures. This type of activity is no longer extraordinary.

The large bank program allows the State and FDIC to develop a more thorough knowledge of the bank than is possible through the traditional regime of periodic, discrete examinations. Over the four years Utah has been involved in this program, we have developed, tested, and refined this supervisory approach expressly to address the special financial and compliance challenges posed by bigger, more complex and to some degree globally positioned banks.

Today, our industrial banks operate nationally but they may have affiliates or relationships that operate overseas, as well as our neighboring countries to the north and to the south.

This expansion of our large industrial bank operations' across various legal entities and geographic boundaries puts an increased premium on coordinating our supervisory responsibilities with our federal regulatory counterparts and foreign regulators. Nationally, Utah participates as a full partner in their supervisory reviews. Utah shares the reports of examinations. In the large bank program, Utah shares information on proposed examination and supervisory activities for the coming year and coordinate the planning and execution of those programs.

Some industrial banks tend to specialize in specific banking activities such as credit card, home mortgage, automobile, agricultural, loans secured by brokerage accounts or small business lending. This specialization has resulted in critics challenging the safety and soundness of these institutions. However, the FDIC has stated that industrial banks are no more a threat to the deposit insurance fund than commercial banks.

The supervisory approach employed by Utah and the FDIC has been described as *"Bank-Centric"*. Please review the John Douglas quote within the next section dealing with Banking & Commerce for a more detailed discussion of the *"Bank-Centric"* approach. This is not a new concept when examining a bank that is part of a holding company structure. Industrial banks based in Utah have been a "laboratory" 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.

ADDITIONAL PRUDENTIAL SAFEGUARDS APPLIED TO INDUSTRIAL BANKS

While the track record of Utah industrial banks after more than twenty years of dual supervision from the state and FDIC is excellent. Utah believes that this good record of safety and soundness is in part attributable to additional prudential safeguards applied to the industrial banks operating from Utah. Supervising industrial banks is an evolving regulatory dynamic as new issues arise and new lessons are learned, I suspect we will add new requirements.

This enhanced regulatory hand is most evident in approval Orders of de novo industrial banks. The Order is where the majority of prudential safeguards are issued and remain in effect for the life of the institution. These Orders reflect generally higher capital standards and more regulatory attention to potential problems.

Today, all Utah industrial bank approval Orders issued by the department contain the following:

> The board of directors shall be comprised of a majority of outside-unaffiliated directors, and those unaffiliated directors shall not serve on the board of any other

FDIC insured depository institution. (Note that these director independence requirements were imposed long before the Sarbanes Oxley Act of 2002.)

There shall be no change in the executive officers or in the board of directors as submitted in the application without the prior approval of the Commissioner for a period of three (3) years after the industrial bank commences operations.

Requires at a minimum an onsite President, the Chief Financial Officer, and the Chief Credit Officer with sufficient support staff with the knowledge, ability, and expertise to successfully manage the risks of the industrial bank, maintain direct control of the industrial bank, and retain the industrial banks independence from the parent company.

Within 30 days of receiving all required regulatory approval to operate as an insured Utah industrial bank, the industrial bank holding company shall register with the department by filing a registration statement as required by Utah law.

EXAMINE THE FACTS IN A WORST CASE SCENARIO

In this discussion and others the worst case scenario that detractors have postulated is that of a holding company filing bankruptcy or getting into financial difficulty. The reality is that Utah and the FDIC have experienced both. While no regulator relishes stressful circumstances, we can state that we weathered the storm. Utah has had large corporate parents of industrial banks encounter financial difficulties, and in one instance the ultimate parent company filed for bankruptcy protection.

The background and outcome were well described by the FDIC in the January 2005, *FDIC Banking Review, The Mixing of Banking and Commerce: Current Policy Issues,*

> *"The bankruptcy of the corporate owner of an ILC - Conseco Inc - but not of the ILC itself illustrates how the bank-up approach can effectively protect the insured entity without there being a BHC-like regulation of the parent organization. Conseco Inc. was originally incorporated in 1979 as Security National of Indiana Corp. After several years of raising capital, it began selling insurance in 1982. Security National of Indiana changed its name to Conseco Inc. in 1984, after its 1983 merger with Consolidated National Life Insurance Company. Conseco Inc. expanded its operations throughout the 1980s and 1990s by acquiring other insurance operations in the life, health, and property and casualty areas. Conseco Inc. was primarily an insurance company until its 1998 acquisition of Green Tree Financial Services. A diversified financial company, Green Tree Financial Services was one of the largest manufactured-housing lenders in the United States. Upon acquisition, it was renamed Conseco Finance Corporation. Included in the acquisition were two insured depository charters held by Green Tree Financial Services - a small credit-card bank chartered in South Dakota and an ILC chartered in Utah. Both of these institutions were primarily involved in*

issuing and servicing private-label credit cards, although the ILC also made some home improvement loans. The ILC - Green Tree Capital Bank - was chartered in 1997 and changed its name to Conseco Bank in 1998 after the acquisition. Conseco Bank was operated profitably in every year except the year of its inception, and grew its equity capital from its initial $10 million in 1997 to just over $300 million in 2003. Over the same period, its assets ballooned from $10 million to $3 billion".

"Conseco Bank was supervised by both the Utah Department of Financial Institutions and the FDIC. Despite the financial troubles of its parent and the parent's subsequent bankruptcy (filed on December 18, 2002), Conseco Bank's corporate firewalls and the regulatory supervision provided by Utah and the FDIC proved adequate in ensuring the bank's safety and soundness. In fact, $323 million of the $1.04 billion dollars received in the bankruptcy sale of Conseco Finance was in payment for the insured ILC - Conseco Bank, renamed Mill Creek Bank -which was purchased by GE Capital. As a testament to the Conseco Bank's financial health at the time of sale, the $323 million was equal to the book value of the bank at year-end 2002. Thus, the case of Conseco serves as an example of the ability of the bank-up approach to ensure that the safety and soundness of the bank is preserved."

In another case, TYCO, a large parent company of a Utah industrial bank called CIT Online Bank encountered financial difficulties and decided to spin the industrial bank group off in an initial public offering which was approved and completed. In spite of TYCO's financial difficulties, the Utah industrial bank continues operations today as CIT Bank.

BANKING & COMMERCE

In discussing industrial banks one often reads of the need to *"restore the traditional separation of banking and commerce"* that industrial banks exist because of a *"loophole"* in the Bank Holding Company Act.

Those that state there is and should be a separation of banking and commerce believe that this is a fundamental principle incorporated by the passage of the Glass-Steagall Act in 1933 while others believe that if there ever was a separation between banking and commerce it was eviscerated with the passage of the Gramm-Leach-Bliley Act of 1999.

The proponents of the former argument subscribe to the conclusion that great *"evils"* result when banking and commerce are mixed. That somehow these great *"evils"* are compounded by the fact that Congress left this gaping hole through an oversight and this *"loophole"* may be exploited by commercial companies that will endanger the safety and soundness of our financial services sector and the deposit insurance funds.

Utah believes that the written testimony submitted by John L. Douglas, a former General Counsel of the FDIC, before the Subcommittee on Financial Institutions and Consumer Credit in July 12, 2006, states well our views on the primary issue of mixing banking and commerce and we incorporate a part of his testimony as ours.

> *"These first two assertions are simply historically inaccurate, and ignore the fact that throughout our history there have long been affiliations between banks and commercial firms. Indeed many of these have been expressly blessed by Congress. We should be clear on this point. Such affiliations have always existed. Congress has chosen to limit certain of them from time to time, by the Bank Holding Company Act, the Competitive Equality Banking Act, the Federal Deposit Insurance Corporation Improvement Act and the Gramm-Leach-Bliley Act each address and bless, and regulate commercial affiliations with banks."*

He states in his footnote number 1 on the Glass-Steagall Act that,

> *"The Glass-Steagall Act separated to a limited degree investment and commercial banking. The separation was never absolute; indeed, it was substantially eroded by regulatory interpretations by the Federal Reserve in the 1980's and 1990's. Whatever separation remained was essentially eviscerated by the adoption of the Gramm-Leach-Bliley Act in 1999."*

Mr. Douglas also stated in footnote number 3 that,

> *"I will not repeat the arguments that have been presented before Congress many times in the past on the first two assertions. As to the "historic" separation of banking and commerce, I will merely note that it wasn't until 1956 that activity restrictions were place on multi-bank holding companies and that those restrictions weren't extended to single bank holding companies until 1970. Further, it wasn't until 1999 that activity restrictions were imposed on unitary savings and loan holding companies. As for the "unintended loophole," Congress has extensively considered industrial loan banks on numerous occasions, most extensively as part of the Competitive Equality Banking Act in 1987, and again as part of the Gramm-Leach-Bliley Act in 1999."*

He then goes on to address his key points which are germane for our discussion.

> *"Another assertion that has recently been made is that the unregulated owners of industrial banks would wreck havoc on our financial system given the lack of "comprehensive supervision" of the corporate owners of such institutions. This last proposition ignores the existing legal framework governing all financial institutions, including industrial loan banks, and ignores the substantial power and authority (and indeed belittles the capacity) of the FDIC to supervise, examine and enforce laws, rules and regulations that are intended to assure safety and soundness, as well as prevent abuses that might possibly arise from affiliations between banks and commercial affiliates.*

"It is this last assertion that I particularly wish to address, that somehow the lack of comprehensive supervision poses a threat to our financial system. I make four major points in response:

"First, industrial loan banks are subject to the same comprehensive framework of supervision and examination as "normal" commercial banks. They have no special powers or authorities; they are exempt from no statute or regulation. They must abide by the requirements of: Sections 23A and B, limiting and controlling transactions with affiliates; Regulation O, governing loans to officers, directors or their related interests; capital requirements; the Prompt Corrective Action safeguards instituted by Congress in the early 1990's that assure maintenance of adequate capital and impose an ever-increasing level of supervisory control if institutions fail to do so; and all of the other laws, rules and regulations that promote safe and sound banking in this country.

"Second, the FDIC has been given full and ample authority to supervise and regulate these institutions, and can exercise the full range of enforcement authorities granted by Congress. I was a participant in the political process that led to Congress' rewrite of those provisions in 1989, as part of FIRREA, and I personally can attest to the scope of the cease and desist, removal and prohibition, civil money penalty and withdrawal of deposit insurance powers. Given the magnitude of the 1980's financial debacle and the great concerns in Congress that it never happen again, we at the FDIC at that time worked closely with members of this Committee and others in Congress with the clear intention to give the FDIC and the other bank regulators all of the supervisory and enforcement powers they would ever need to protect the banking system. We wanted to be sure that no future banking failures would be the result of a lack of FDIC authority and tools to address threats to a bank's safety-and-soundness, including threats that might arise from its nonbanking affiliates.

"Importantly, all of these enforcement powers apply with full force to an industrial loan bank, as well as to any officer, director, controlling shareholder or "any other person . . . who participates in the conduct of the affairs of an insured depository institution." There is no question that to the extent that either the corporate owner of an industrial loan bank or any affiliate of that owner engages in any violation of law, rule or regulation applicable to the industrial loan bank, or has engaged, is engaging or is about to engage in an unsafe or unsound practice relating to the industrial loan bank, the FDIC can bring the full range of enforcement authorities to bear. These remedies can include not only requiring that impermissible or inappropriate activities cease immediately, but also requiring that the condition be remedied and restitution made. Civil money penalties up to one million dollars per day can be imposed, and individuals can be removed from their positions and precluded from having any involvement not only with the industrial loan bank but with any insured depository institution. The FDIC can also restrict the activities of the industrial loan bank or any affiliate participating in its affairs, can withdraw the deposit insurance of the industrial

loan bank and take any other action it "deems appropriate" in the event of a violation of law, rule or regulation, including in my opinion even forcing the divestiture of the industrial loan bank by its owner.

"Third, I can attest from experience that the FDIC regularly and vigorously exercises these powers. The FDIC routinely requires an independent, fully functioning board of directors designed to assure that the industrial loan bank stands on its own and is not merely an arm of its corporate owner. The industrial loan bank must have adequate capital, operate in a safe and sound fashion, avoid unsafe and unsound practices, have comprehensive policies, controls and procedures, and an effective internal audit program. The FDIC rigorously examines the institution and closely scrutinizes transactions and relationships between the industrial loan bank and its affiliates. It conditions approvals to assure compliance with carefully crafted commitments designed to assure the safe and sound operations of the industrial loan bank. It forcefully uses its enforcement powers, and is not shy about inquiring about any action, transaction or relationship that might potentially affect the insured institution.

"Fourth, the experience of the FDIC with respect to industrial loan banks, similar to the experience of the OTS with respect to diversified owners of savings associations, belies any fundamental concerns over threats to the banking system or our economy that might arise from commercial ownership. There have only been two failures of FDIC-insured industrial loan banks owned by holding companies. These holding companies were not commercial (i.e., a non-financial) enterprises. These two failures cost the FDIC roughly $100 million. Both failed not as a result of any self dealing, conflicts of interest or impropriety by their corporate owners; rather, they failed the "old fashioned way" by poor risk diversification, imprudent lending and poor controls. These two failures stand in sharp contrast to the hundreds of bank failures that operated in holding company structures, many of which cost the FDIC billions of dollars. The list is long and sobering - Continental Illinois, First Republic, First City, MCorp, Bank of New England, and so on - all of which were subject to the much-vaunted "consolidated supervision" by the Federal Reserve as the holding company regulator that offered as cure for something that hasn't proven to be a problem.

"And we should be very clear about a fundamental point. ***Throughout our history to now, there have always been, and federal law has always allowed, affiliations between "banking" and "commerce."*** *In our modern era, these relationships have been carefully considered, and accompanied by a statutory and regulatory framework assuring that our regulatory authorities have ample power to protect against abuses and problems.*

"Moreover, both consumers and our economy have unquestionably benefitted from the hundreds of banking-commerce affiliations that have long existed, and continue to exist. Congress should consider very carefully the full implications of any change in law that could choke off these affiliations and deny our financial

> *system the flexibility and innovation that it always has had in the past. It would indeed be unwise to roll back the clock by taking steps to limit healthy and beneficial competition under the guise of advancing an idea that may have an attractive rhetorical resonance, but in fact is simply irrelevant to the issue at hand."*

The industrial bank experience, like the experience of credit card banks, non-bank banks and other institutions with commercial parents, shows that fears about banking and commerce are unfounded. The history of industrial banks is a testament that the regulatory model has maintained the safety and soundness of these institutions. The track record demonstrates that banks can be safely operated as parts of diversified holding companies.

HOLDING COMPANY SUPERVISION

The bank holding company model works well for companies whose principal business is limited to banking - it was devised at a time when bank holding companies were permitted to do nothing else. The existing industrial bank supervisory process works well. Utah believes it is the *"superior"* model for holding companies whose principal business may not be banking.

What has received very little coverage in the current debate is the fact that industrial bank oversight by the states and the FDIC is supplemented by holding company oversight by federal financial regulators other than the Federal Reserve. The Office of Thrift Supervision (OTS) and Securities and Exchange Commission (SEC) have regulatory oversight over many holding companies with Utah industrial bank subsidiaries.

As previously stated, the OTS has supervisory responsibilities at five Utah industrial bank holding companies whose industrial banks collectively constitute 58% of all Utah industrial bank assets. The OTS has holding company jurisdiction because of affiliated federal savings banks to the Utah industrial banks.

The SEC has Consolidated Supervisory responsibility over Goldman Sachs Bank's holding company whose industrial bank holds approximately 7% of total Utah industrial bank assets. The SEC has dual consolidated supervision authority with the OTS over three additional Utah industrial banks in total representing 53% of Utah assets.

The Federal Reserve has holding company supervision of UBS Bank's parent company (which holds approximately 11% of total Utah industrial bank assets) because UBS's parent filed as a Financial Holding Company with the Federal Reserve.

The federal agency oversight listed above constitutes approximately 77% of all Utah industrial bank assets as of June 30, 2007. This is not a parallel regulatory structure when federal agencies have holding company authority over 77% of all Utah industrial bank assets.

While not included in the federal agency oversight totals above, consideration should be given to three additional Utah industrial banks: Advanta Bank with $2.0 billion in total assets, Target Bank with $15 million, and World Financial Capital Bank with $177 million in total assets, all of which have sister national banks chartered by the Office of the Comptroller of the Currency (OCC).

Again, trying to keep this discussion in perspective, the entire industrial bank industry, even with its growth during the last twenty years, represents only approximately 1.8% of U. S. banking assets.

The parent companies of the vast majority of Utah industrial bank assets are engaged exclusively or predominantly in financial services activities. These include: Advanta, American Express, Merrill Lynch, Morgan Stanley and UBS. Other industrial banks are owned by diversified companies, such as General Electric and GMAC which engage in both financial and non-financial activities. Some are controlled by companies primarily engaged in commercial or industrial activities, such as BMW and Volkswagen. However, both BMW and Volkswagen have extensive banking operations in Europe.

While not subject to regulation as bank holding companies, industrial bank owners are subject to many of the same requirements as bank holding companies. As a result, safeguards already exist to protect these depository institutions against abuses by the companies that control them or activities of affiliates that might jeopardize the safety and soundness of the institutions or endanger the deposit insurance system.

For example, restrictions on transactions with affiliates in Sections 23A and 23B of the Federal Reserve Act apply to industrial banks and their owners. These provisions limit the amount of affiliate loans and certain other transactions (including asset purchases) to 20 percent of a bank's capital, and require that such loans be made on an arm's length basis. Thus, an industrial bank may not lawfully extend significant amounts of credit to its holding company or affiliates or offer credit to them on preferential or non-market terms. All loans by industrial banks to their affiliates must be fully collateralized, in accordance with Section 23A requirements. A recent Federal Reserve clarification requested by the FDIC on the ARCUS Financial Bank application is that the holding company activities are "*complimentary to banking*" and permissible for a Financial Holding Company.

Utah law establishes, besides all other jurisdiction and enforcement authorities over industrial banks, that pursuant to Section 7-8-16 each industrial bank 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 industrial bank holding company is subject to examination and enforcement authority of the Department.

Utah struggles to understand why Congress would want to keep out well-capitalized innovative entrants to the market? While the banking system is becoming concentrated in the hands of a few large institutions with huge market power and system risk, I

understand that the five largest banks are trillion dollar entities. These entities control a third of industry assets and deposits, and a fourth of all bank branches.

SUMMARY

Utah has been successfully regulating FDIC insured industrial banks for twenty years. Utah has established a record of safe and sound institutions with prudential safeguards in place that have prevented parent companies from exercising undue influence over the insured entity.

Utah's industrial banks are well capitalized, safe and sound institutions.

Utah's industrial banks are subject to the same regulations and are examined in the same manner as other banks.

Utah and FDIC examiners have adapted as the industrial banks have evolved. For us, keeping up with new products, new financial instruments and new delivery mechanisms has been a regulatory challenge, but a challenge we have met with the shared resources of our regulatory partner, the FDIC.

In this discussion, the reality check is that the entire industrial loan industry, even with its growth of the last twenty years, is only approximately 1.8% of banking assets.

31 IBs as of 6-30-07	6/30/2007 Total Assets	Federal Holding Company Supervisor	Financial or Non-financial
ADVANTA BANK CORP	2,011,368		Financial
ALLEGIANCE DIRECT BANK	45,257		Financial
AMERICAN EXPRESS CENTURION BANK	23,419,480	OTS	Financial
BMW BANK OF NORTH AMERICA	2,365,047		Non-financial
CAPMARK BANK (gmaccm)	6,616,762		Non-financial
CELTIC BANK	119,536		Financial
CIT BANK	4,065,554		Financial
ENERBANK	150,131		Non-financial
ESCROW BANK USA	33,563		Non-financial
EXANTE BANK, INC.	524,824		Financial
FIRST ELECTRONIC BANK	14,001		Non-financial
GE CAPITAL FINANCIAL INC	2,217,336	OTS	Non-financial
GMAC BANK	23,450,998		Non-financial
GOLDMAN SACHS BANK USA	15,028,045	SEC	Financial
LCA BANK CORPORATION	24,882		Financial
LEHMAN BROTHERS COMMERCIAL BANK	3,431,671	OTS/SEC	Financial
MAGNET BANK, INC.	504,147		Financial
MEDALLION BANK	323,075		Financial
MERRICK BANK	1,118,990		Financial
MERRILL LYNCH BANK USA	60,879,265	OTS/SEC	Financial
MORGAN STANLEY BANK	27,391,000	OTS/SEC	Financial
REPUBLIC BANK INC	482,419		Financial
SALLIE MAE BANK	807,283		Financial
TARGET BANK	15,321		Non-financial
THE PITNEY BOWES BANK INC	664,309		Non-financial
TRANSPORTATION ALLIANCE BK	507,002		Non-financial
UBS BANK USA	23,090,817	Federal Reserve	Financial
VOLKSWAGEN BANK USA	288,023		Non-financial
WEBBANK	22,493		Financial
WORLD FINANCIAL CAPITAL BANK	177,424		Financial
WRIGHT EXPRESS FINANCIAL SERVICES	1,108,181		Financial
TOTAL UTAH INDUSTRIAL BANK ASSETS	**200,898,204**		
percentage of total ILC assets nationwide (59 banks)	89.0%		
percentage of total insured banks/S&Ls (8,615 banks)	1.6%		

(Numbers in 000s)

FDIC INSURED ILC/IBS By Year	Charters Operating	Total Assets
Beginning December 31, 1986	**19**	**474,066,764**
1987	10	429,625,000
1988	13	555,030,000
1989	15	835,036,000
1990	15	1,551,042,000
1991	15	1,360,393,000
1992	15	1,001,663,000
1993	13	1,198,808,000
1994	12	1,845,190,000
1995	13	2,993,882,000
1996	13	13,489,138,000
1997	16	15,373,706,000
1998	18	17,738,307,000
1999	20	29,670,874,000
2000	23	74,576,488,000
2001	23	98,304,191,000
2002	24	103,383,111,000
2003	27	110,422,054,000
2004	29	115,044,017,000
2005	32	123,428,502,000
2006	32	186,195,692,000
June 30, 2007	31	200,898,204,000

20 "FINANCIAL" 31 IBs as of 6-30-07	6/30/2007 Total Assets	Federal Holding Company Supervisor	Financial or Non-financial
ADVANTA BANK CORP	2,011,368		Financial
ALLEGIANCE DIRECT BANK	45,257		Financial
AMERICAN EXPRESS CENTURION B	23,419,480	OTS	Financial
CELTIC BANK	119,536		Financial
CIT BANK	4,065,554		Financial
EXANTE BANK, INC.	524,824		Financial
GOLDMAN SACHS BANK - USA	15,028,045	SEC	Financial
LCA BANK CORPORATION(1-26-06)	24,882		Financial
LEHMAN BROTHERS COMMERCIAL BANK	3,431,671	OTS/SEC	Financial
MAGNET BANK, INC.	504,147		Financial
MEDALLION BANK	323,075		Financial
MERRICK BANK	1,118,990		Financial
MERRILL LYNCH BANK USA	60,879,265	OTS/SEC	Financial
MORGAN STANLEY BANK	27,391,000	OTS/SEC	Financial
REPUBLIC BANK INC	482,419		Financial
SALLIE MAE BANK	807,283		Financial
UBS BANK USA	23,090,817	Federal Reserve	Financial
WEBBANK	22,493		Financial
WORLD FINANCIAL CAPITAL BANK	177,424		Financial
WRIGHT EXPRESS FINANCIAL SERVICES	1,108,181		Financial
TOTAL "FINANCIAL" INDUSTRIAL BANKS	**164,575,711**		
percentage of total Utah Industrial Banks (31 banks)	81.9%		
percentage of total ILC assets nationwide (59 banks)	72.9%		
percentage of total insured banks/S&Ls (8,615 banks)	1.3%		

(Numbers in 000s)

11 "NON-FINANCIAL" 31 IBs as of 6-30-2007	6/30/2007 Total Assets	Federal Holding Company Supervisor	Financial or Non-financial
BMW BANK OF NORTH AMERICA	2,365,047		Non-financial
CAPMARK BANK (gmaccm)	6,616,762		Non-financial
ENERBANK	150,131		Non-financial
ESCROW BANK USA	33,563		Non-financial
FIRST ELECTRONIC BANK	14,001		Non-financial
GE CAPITAL FINANCIAL INC	2,217,336	OTS	Non-financial
GMAC BANK	23,450,998		Non-financial
TARGET BANK	15,321		Non-financial
THE PITNEY BOWES BANK INC	664,309		Non-financial
TRANSPORTATION ALLIANCE BK	507,002		Non-financial
VOLKSWAGEN BANK USA	288,023		Non-financial
TOTAL "NON-FINANCIAL" INDUSTRIAL BANKS	36,322,493		
percentage of total Utah Industrial Banks (31 banks)	18.1%		
percentage of total ILC assets nationwide (59 banks)	16.1%		
percentage of total insured banks/S&Ls (8,615 banks)	0.3%		

(Numbers in 000s)

7 UTAH INDUSTRIAL BANKS WITH OTS, FRB OR SEC HOLDING CO. SUPERVISION 31 IBs as of 6-30-07	6/30/2007 Total Assets	Federal Holding Company Supervisor	Financial or Non-financial
UBS BANK USA	23,090,817	Federal Reserve	Financial
AMERICAN EXPRESS CENTURION BANK	23,419,480	OTS	Financial
GE CAPITAL FINANCIAL INC	2,217,336	OTS	Non-financial
GOLDMAN SACHS BANK - USA	15,028,045	SEC	Financial
LEHMAN BROTHERS COMMERCIAL BANK	3,431,671	OTS/SEC	Financial
MERRILL LYNCH BANK USA	60,879,265	OTS/SEC	Financial
MORGAN STANLEY BANK	27,391,000	OTS/SEC	Financial
TOTAL "OTS FRB SEC" INDUSTRIAL BANKS	**155,457,614**		
percentage of total Utah Industrial Banks (31 banks)	77.4%		
percentage of total ILC assets nationwide (59 banks)	68.9%		
percentage of total insured banks/S&Ls (8,615 banks)	1.3%		

(Numbers in 000s)

October 4, 2007

Testimony of

Edward L. Yingling

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Committee on Banking, Housing and Urban Affairs

Of the

United States Senate

Testimony of Edward L. Yingling
President and Chief Executive Officer
of the
American Bankers Association
before the
Committee on Banking, Housing and Urban Affairs
of the
United States Senate

October 4, 2007

Mr. Chairman and members of the Committee, my name is Edward L. Yingling. I am President and Chief Executive Officer of the American Bankers Association ("ABA"). The ABA brings together all categories of financial institutions to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, and savings banks—makes ABA the largest banking trade association in the country.

Thank you for the opportunity to present the ABA's views on the regulation of industrial loan corporations ("ILCs"). The ILC industry has changed dramatically in the last several years. Since Congress last enacted legislation concerning the ownership of ILCs, the industry has experienced extraordinary growth both in size and scope. We are very concerned that we have reached a point where prior decisions by Congress that were designed to maintain separation between banking and commerce would be permanently undermined.

Allowing non-financial commercial firms to engage in banking activities carries inherent risks, such as conflicts of interest and misallocation of credit. Congress has recognized these risks and has repeatedly curtailed the ability of non-financial firms to

engage in banking. We urge the Congress to enact legislation that would maintain the long-standing separation between banking and commerce.

In my statement today I would like to make three points:

- The current policy toward ILCs is inconsistent with the long-standing tradition of separating banking and non-financial commerce.

- The ILC exemption created by Congress in 1987 is no longer appropriate for the ILC industry of today.

- Congress should once again prevent the mixing of banking and non-financial commerce.

These points are addressed in further detail below.

I. The Current Policy Toward ILCs is Inconsistent With the Longstanding Tradition of Separating Banking and Non-Financial Commerce.

The separation of banking and commerce has long been a feature of U.S. law. Exploitation of the ILC exemption threatens to undermine this consistent policy.

Over the past 50 years, Congress has repeatedly curtailed the ability of non-financial commercial entities to engage in banking activities. The Bank Holding Company Act, passed in 1956, was designed in part to restrain the ability of commercial firms and

financial institutions to organize under a single holding company. It prohibited commercial firms from owning banks and also prohibited holding companies that owned two or more banks from engaging in non-financial commercial activities.

However, the law did not prevent holding companies that owned only a single bank from also owning non-financial commercial entities. Some non-financial entities stepped into this void and organized under so-called "one-bank" holding companies. By 1970 there were more than 700 such companies, and Congress determined to curtail this activity. Amendments to the Bank Holding Company Act prohibited non-financial commercial entities from owning a single bank through "one-bank" holding companies.

Despite the change, some commercial entities still sought ways to engage in banking activities. At the time of the 1970 amendments, the definition of "bank" in the Bank Holding Company Act included only entities that offered commercial loans *and* accepted demand deposits. A number of large retail commercial entities exploited this provision by acquiring financial institutions that made loans but did not offer demand deposits. These so-called non-bank banks allowed commercial entities to avoid supervision as bank holding companies while offering banking services on an interstate basis.

Once again, Congress intervened to address the situation and enacted the Competitive Equality Banking Act ("CEBA") in 1987. One of the primary purposes of this legislation was to subject non-bank banks to interstate banking restrictions. CEBA prohibited the creation of any new non-bank banks and amended the definition of "bank" in the Bank Holding Company Act to mean any institution that was insured by the Federal Deposit Insurance Corporation ("FDIC"). Thus, CEBA blocked the ability of prospective

owners of non-bank banks to create more institutions that combined banking and commerce.

Most recently, Congress enacted the Gramm-Leach-Bliley Act, which allows financial holding companies ("FHCs") to own commercial banks, securities houses, insurance companies, and other financial entities. Commercial firms may not be, or own, FHCs. Moreover, the Gramm-Leach-Bliley Act put an end to the ability of non-financial commercial firms to become unitary thrift holding companies. The report of the Senate Banking Committee states that "[a]llowing these thrifts to be acquired by commercial firms would move far down the road toward mixing banking and commerce, with all its attendant dangers."[1]

Thus, the legislative history is clear. Time and again Congress has enacted or amended legislation with the specific goal of maintaining separation between banking and non-financial commerce. Expanded use of the ILC exemption threatens to undermine this consistent policy and reduce the flexibility that is central to our banking system and to our economy.

In the long run, the ability of commercial firms to own banks would profoundly change our banking system, causing it to become more concentrated and rigid.

II. The Full ILC Exemption Created By Congress in 1987 is no Longer Appropriate for the ILC Industry of Today.

The first ILCs appeared in the early 1900s when a few states began chartering them for the purpose of making loans to low- and moderate-income industrial workers. Because

[1] Senate Report 106-44 of the Committee on Banking, Housing, and Urban Affairs, April 28, 1999.

state laws at the time generally did not permit ILCs to accept deposits, they funded themselves by issuing to investors certificates of investment or indebtedness, dubbed thrift certificates. As such, ILCs were not considered banks and were not eligible for FDIC insurance or subject to state or federal banking regulations.

By the time Congress enacted CEBA and amended the definition of "bank" to include any financial institution that is FDIC insured, most ILCs were FDIC insured, and some states even *required* them to be in order to keep their charters. This meant that ILCs fell squarely within the new definition of "bank" and could not be owned by non-financial commercial entities. However, Congress also included an exemption in CEBA specifically stating that the term "bank" does not generally include ILCs if they meet one of a handful of conditions.[2] Interestingly, the legislative history of CEBA does not offer much insight as to why the ILC exemption was included. In recent testimony, the Federal Reserve Board makes note of this fact and suggests that the exemption may be due to the fact that the size, nature and powers of ILCs were rather limited in 1987.[3]

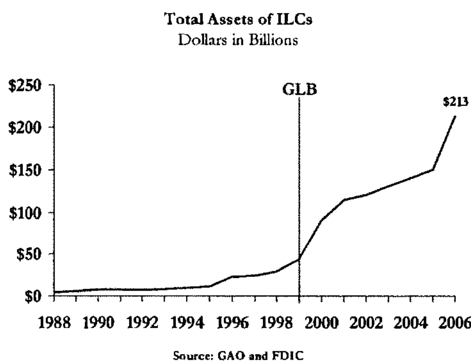
Indeed, ILCs were originally created to provide uncollateralized consumer loans to workers unable to obtain such loans from existing commercial banks.[4] At the time CEBA was enacted, most ILCs had less than $50 millon in assets and the exemption applied to only a few, small institutions. Furthermore, the few states that were able to charter ILCs – principally California, Nevada, and Utah – were not promoting the charter. In fact, Utah had a moratorium at the time on the creation of new ILCs.

[2] The conditions include: (1) the ILC does not accept demand deposits that can be withdrawn by check or similar means; (2) the ILC maintains total assets of less than $100 million; or (3) the ILC has not undergone a change in control after 1987. Only ILCs chartered in states that, as of March 5, 1987, had in effect or under consideration a law requiring ILCs to be FDIC insured were eligible for the exemption.
[3] Testimony of Scott G. Alvarez, General Counsel of the Board of Governors of the Federal Reserve System, before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, House of Representatives, July 12, 2006.
[4] GAO-05-621 *Industrial Loan Companies*, September 15, 2005.

Simply put, there was no significant risk that problems caused by mixing banking and non-financial commerce would arise from the ILCs that existed at the time that the exemption was codified.

This is not the case today. Between 1987 and June 2007, aggregate ILC assets grew more than 5,800 percent, from $3.8 billion to $225 billion, with the average ILC holding close to $3.8 billion in assets.

This growth is not by accident. Enactment of the Gramm-Leach-Bliley Act in 1999 cut off the ability of non-financial commercial entities to engage in bank-like activities through unitary thrift holding companies. Commercial firms that still wanted to engage in banking activities were forced to look for other means of doing so. It is no coincidence that a monumental increase in total aggregate assets held by ILCs occurred shortly after Gramm-Leach-Bliley was enacted. According to a recent report by the Government Accountability Office, total ILC assets amounted to over $43.6 billion in 1999. In 2000, total ILC assets more than doubled to over $90 billion.[5] As noted, total aggregate assets reached almost $213 billion in 2006 and today exceed $225 billion.



Even during the debate leading up to enactment of Gramm-Leach-Bliley there was significant activity with respect to ILC asset growth. The major tenets of that landmark legislation had been under discussion for years in Congress. In 1995, the first bill

[5] GAO-05-621 *Industrial Loan Companies*, September 15, 2005.

addressing ownership of unitary thrift holding companies was introduced. Though not enacted at the time, the Financial Services Competitive Act of 1995 sent a clear signal that curtailing the ability of non-financial commercial firms to own a unitary thrift holding company would be a part of the debate going forward. It also provided impetus for commercial firms to shift their assets from thrifts to ILCs. Indeed, between 1995 and 1999, the year Gramm-Leach-Bliley was enacted, total aggregate ILC assets almost quadrupled from $11.5 billion to $43.6 billion.

Thus, when Congress finally closed the unitary thrift avenue in 1999, non-financial commercial entities that still wanted to engage in financial activities rushed to exploit another. This time they turned to the ILC exemption that Congress had created more than a decade earlier. Because federal law places very few restrictions on the types of activities that an ILC operating under the exemption may conduct, commercial firms wanting to engage in banking turned to ILCs as a viable option. A recent report by the FDIC states that "the ILC charter has been an attractive choice for companies that are not permitted to, or choose not to, become subject to the restrictions of the [Bank Holding Company Act]. As a result, it is not surprising that the parent companies of ILCs include a diverse group of financial, and where permitted, commercial firms."[6]

Furthermore, while the ILCs may only be chartered in a handful of states, there is no limit to the number of ILCs these states may charter. To date, there are a total of 61 FDIC insured ILCs nationwide, with seven pending applications.

Federal law allows ILCs to effectively compete with full-service insured depository institutions. ILCs may branch across state lines to the same extent as other types of insured banks, and modern technology ensures that ILCs have the ability to conduct their

[6] FDIC Banking Review, 2004, Volume 16, No. 4 at 113.

activities nationwide, even without physical branches. As observed by former Federal Reserve Chairman Alan Greenspan, ILCs may engage in the "full range of commercial, mortgage, credit card and consumer lending activities; offer payment-related services, including Fedwire, automated clearing house and check clearing services, to affiliated and unaffiliated persons; [and] accept time and savings deposits, including certificates of deposit from any type of customer."[7]

Hence, the industrial banks of today do not resemble the small ILCs of yesteryear that were created to make uncollateralized loans to industrial workers. They are increasingly large, sophisticated firms. We have a real danger that provisions of law intended for a limited purpose will be increasingly in a manner that contravenes the consistent desire of Congress to maintain separation between banking and non-financial commerce.

III. Congress Should Once Again Prevent the Mixing Of Banking and Commerce

In its current form, the ILC exemption threatens to erode the separation of banking from non-financial commerce. Congress should act, as it has many times before, to ensure that the potential dangers associated with this erosion do not become a reality. The rationale for maintaining separation between banking and non-financial commerce is clear. Banking is a critical component of our economy and is carefully regulated for safety, soundness, and systemic risk.

[7] Letter from Federal Reserve Board Chairman Alan Greenspan to Congressman James Leach dated January 20, 2006.

Allowing banks to mix with commercial firms raises a host of issues. Among these, previously identified by Congress, is the potential for a conflict of interest, particularly in decisions concerning extensions of credit. Congress has long been concerned that a non-financial commercial firm could pressure or otherwise encourage a bank subsidiary to grant credit to customers of the firm on favorable terms or refuse to grant credit or stiffen credit terms to the firm's competitors or their customers. Credit decisions based on factors other than the creditworthiness of the borrower and other customary banking considerations have the potential to threaten the safety and soundness of the bank. This runs counter to the general purposes of a bank charter and its obligations to customers, and could be particularly aggravating in smaller communities.

Congress has also raised additional issues. For example, a bank, in order to cope with reputational risk from a non-financial parent or non-financial affiliate, might be tempted to make funding decisions to support the affiliate or its customers that are not in the best financial interests of the bank. Non-financial firms may also be tempted to use a subsidiary bank to serve the firm's commercial purposes instead of serving as a source of strength for the bank.

The recent experience in Japan, where commercial firms have been closely affiliated with banking institutions, provides a striking illustration of the inherent dangers of intermingling banking and commerce. Affiliations such as the keiretsu, where a bank and a commercial firm have substantial cross-shareholding and business ties, and the "main bank system," where a bank has extensive shareholdings in a client firm and serves as the major source of short- and long-term financing, resulted in large bank-firm relationships that dominated the Japanese economy until the latter half of the 1990s. Through such

relationships the main bank typically took responsibility for monitoring the financial health of the commercial firm.

As a result, firms were insulated from the discipline that normally comes from outside directors, shareholders, and creditors. Lenders and affiliated companies were encouraged to support firms when their ability to continue as a going concern came into question. This subversion of corporate governance resulted in suboptimal business and financial decisions, exacerbating the inability of the Japanese economy to fully recover from the sharp economic downturn that began in the early 1990s.

The link to large commercial entities has important consequences for small businesses and new businesses seeking financial support. With preference given to the corporate entity (either explicitly or implicitly), credit is channeled away from smaller businesses. This becomes more acute as credit conditions tighten, as was the case throughout much of the 1990s in Japan. This means that more resources are steered to less efficient firms and away from start-ups or competing businesses that are better positioned to meet economic challenges.

The rigidity of this structure is a large part of the reason why it took so long for the Japanese economy to recover after its bubble burst in the early 1990s. In describing the genesis and solution of the severe economic crisis in Japan, Eric Rosengren (President and CEO of the Federal Reserve Bank of Boston) and Joe Peek (University of Kentucky) concluded:

> One potential source of difficulty in implementing major corporate restructuring has been the web of corporate affiliations that encourages lenders and affiliated companies to support firms that otherwise would have

> been restructured, sold, or liquidated. We show that a primary driver of lending to troubled firms has been the strength of corporate affiliations, and that lenders without such affiliations are much less inclined to allocate additional credit to deeply troubled firms. Further, as banking problems worsened in the latter half of the 1990s, evidence of lending in support of troubled affiliated firms became particularly evident.[8]

By placing relationships ahead of sound business practices that rely on credit risk analysis, Japanese banks engaged in lending policies that resulted in bank failures and massive loan charge-offs. The misallocation of credit inhibited the necessary restructuring of both banks and firms, and since small businesses did not receive the credit they needed, precluded the constant renewing of the economy that occurs through formation of new businesses. For Japanese banks, the consequences have been severe. Consider that in 1989, all of the largest global banks (by market capitalization) were headquartered in Japan. In 2006, only two Japanese banks were on that list (see the table on the following page).

The lessons from the Japanese experience were not lost on Congress. Concern over the long-term effects that result from the intermingling of banking and commerce are part of what prompted Congress to address the unitary thrift holding company issue through the Gramm-Leach-Bliley Act in 1999. Of course, we would not move to a Japanese-like system overnight. However, if the ILC issue is not addressed now, we will have set the stage for a future with a significant concentration of commercial-banking entities that would result in a much more rigid financial system.

[8] Joe Peek and Eric Rosengren, "Corporate Affiliations and the (Mis)Allocation of Credit NBER Working Paper 9643, 2002. See also "Unnatural Selection: Perverse Incentive and the Misallocation of Credit in Japan, *American Economic Review*, 2005, Volume 95, Issue 4.

Simply put, any general mixing of banking and commerce is likely to be difficult to disentangle down the road. Congress has recognized this many times before and has consistently acted to prevent the dangers that accompany it from becoming reality.

Largest Global Banks by Market Capitalization
Ranked by Market Capitalization ($ in Billions)

1989		2006	
Institution	Country	Institution	Country
Industrial Bank	Japan	Citigroup	United States
Sumitomo	Japan	Bank of America	United States
Dai-Ichi Kangyo	Japan	HSBC	China
Fuji	Japan	JPMorgan Chase	United States
Mitsubishi	Japan	Mitsubishi UFJ	Japan
Sanwa	Japan	Wells Fargo	United States
Nomura	Japan	UBS	Switzerland
Long Term Credit	Japan	Royal Bank of Scotland	United Kingdom
Mitsui	Japan	China Construction Bank	China
Tokai	Japan	Mizuho	Japan

Source: Morgan Stanley, Capital International Perspective

Source: The Economist

By offering a means for non-financial commercial entities to obtain ownership or control of a bank through an ILC charter, the current ILC exemption increases the likelihood that the risks associated with mixing banking and commerce will become problems. The most effective way to remedy the current situation is to limit ownership of insured depository institutions to companies that are financial in nature.

CONCLUSION

The banking system that has developed in the U.S. is unique. Bankers from other countries are often surprised to hear how many banks we have and their array of sizes. This mixture provides flexibility and options for customers, is vital to the growth of our economy, and is particularly important to small businesses and new businesses. In the long run, if commercial firms were allowed to own banks our unique system could become highly concentrated and rigid.

Congress has repeatedly and consistently taken steps to maintain separation between banking and non-financial commerce. ABA urges the Senate to enact legislation that would maintain this separation. We stand ready to work with this Committee and the Congress to enact this important legislation.

TESTIMONY OF
MARC E. LACKRITZ
PRESIDENT AND CEO
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

HEARING ON
"EXAMINING THE REGULATION AND SUPERVISION OF INDUSTRIAL LOAN COMPANIES"

October 4, 2007

Mr. Chairman and members of the Committee:

My name is Marc Lackritz and I am President and CEO of the Securities Industry and Financial Markets Association ("SIFMA").[1] I appreciate the opportunity to testify today on the regulation and supervision of industrial banks because banks owned by SIFMA members hold the majority of all industrial bank assets in the United States.[2]

Congress passed the *Gramm-Leach-Bliley Act* ("GLBA") in 1999 to permit the widest variety of choices for affiliations between and among securities firms, banks and insurance companies. A central objective of GLBA was that each affiliated financial services entity would be functionally regulated – that is, one regulatory agency would apply the same set of rules to the same activity engaged in by any financial institution, regardless of the type of financial institution it may be. The ability to structure their operations optimally within existing law has been critical to the success of industrial

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers locally and globally through offices in New York, Washington D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

[2] Utah-based insured industrial banks have about $200 billion in assets, which is less than two percent of total assets of all FDIC-insured institutions. Securities firms own the largest industrial banks and, collectively, control industrial loan banks that hold more than two thirds of total industry assets and deposits. When combined with the assets and deposits of industrial banks owned by other financial services firms, such as American Express and Advanta Corp., the financial services sector of the industrial loan bank industry comprises over 80 percent of the industry.

banks and their owners. Indeed, many of these companies are among the most advanced, sophisticated, and competent providers of financial services anywhere. For that reason, SIFMA supports the ability of regulated securities firms to own industrial banks as they do under existing law.[3] We also believe any proposal to expand the existing authority of the Federal Deposit Insurance Corporation ("FDIC") over the owners of industrial banks must provide an exemption for owners who are regulated as "Consolidated Supervised Entities ("CSEs") by the Securities and Exchange Commission ("SEC").

Securities Firms' Ownership of Industrial Loan Banks

Members of the financial services community worked with Congress for decades to pass legislation to permit affiliations between and among securities firms, banks and insurance companies combined with functional regulation. After years of debate, discussion, and numerous failed attempts, Congressional leaders forged a political compromise between the relevant industries and Congress finally passed GLBA. GLBA gave financial services firms several structural options for affiliating with other firms. (1) They can choose to affiliate under a financial services holding company ("FSHC") structure regulated by the Federal Reserve Board, and each of the subsidiary financial services firms are regulated by their respective functional regulators. (2) Holding companies that own securities firms, and operate certain limited-purpose banks, can elect to be regulated as investment bank holding companies ("IBHCs"), which are subject to the jurisdiction of the SEC. (3) Securities firms and other companies can engage in banking activities through industrial loan banks and other special-purpose banks (including savings institutions, "non-bank banks," credit card banks) with supervision by the FDIC and state bank regulators. Securities firms that owned a thrift were permitted to retain their thrifts, subject to holding company supervision by the Office of Thrift Supervision ("OTS").

Although at least one securities firm (Schwab) has elected to organize as a FSHC, most of the securities firms that wanted to provide banking services chose to do so through their affiliated industrial banks. This is because they cannot own full-service commercial banks without exiting businesses that account for substantial segments of their revenues, such as commodities and merchant banking. Many SIFMA members consider these activities critical to their clients' needs and to well-functioning capital markets.

Industrial banks have a remarkably strong record of safety and financial strength. Most industrial banks, and all of the industrial banks owned by SIFMA members, are based in Utah. About 80 percent of Utah's bank assets are held in industrial banks and

[3] As a new organization, SIFMA's Board of Directors reviewed the industrial loan bank issue prior to testifying before the House Financial Services Committee on H.R. 698 on April 25, 2007. The Board strongly supports the position outlined in this testimony, and noted the importance of dealing over the long-term with certain inconsistencies in the regulation of financial products and services (see page 6 for a fuller discussion).

most of those are held in banks owned by SIFMA members. These Utah-based industrial banks serve a nationwide market, conducting more than 95 percent of their business out of state. Utah banks are far and away the strongest in the nation with the highest aggregate tier 1 capital and return on assets.[4]

Importantly, no industrial bank in Utah has failed in the last 20 years, even in one instance when an industrial bank's holding company went bankrupt.[5] In addition, industrial banks have an exemplary record of service to their customers and the community, with nearly 40 percent of the Utah industrial banks examined by the FDIC for compliance with the Community Reinvestment Act receiving "outstanding" ratings.

Regulation of Industrial Banks and their Owners

Securities firms with industrial bank subsidiaries are subject to multiple levels of supervision. Federally insured industrial banks are subject to state banking supervision, FDIC oversight, and all banking laws governing relevant banking activities. Most importantly, the FDIC has authority to examine the affairs of any affiliate of any depository institution, including its parent company.

Securities firms' broker-dealer affiliates are regulated by the SEC, and all of the SIFMA member securities firms with industrial bank subsidiaries have elected more comprehensive enterprise-wide regulation by the SEC acting as their consolidated supervisor. The SEC's jurisdiction does not limit the concurrent authority of the bank regulators. Most of the SIFMA member securities firms that own industrial banks also own savings institutions and are regulated at the holding company level as "savings and loan holding companies" by the OTS.

The FDIC's regulation of the bank and its affiliates, combined with measures to strengthen independent control of the bank, has worked well for securities firms, their customers and shareholders, and the financial services markets. Tested for 20 years on a broad scale and under the normal stresses and market cycles, the FDIC's regulation of industrial banks has proven safe and effective. Industrial banks pose no greater safety and soundness risks than other charter types. Very simply, no case has been made to require additional constraints on the industrial bank charter beyond those imposed on other FDIC-insured institutions.

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[4] Federal Deposit Insurance Corporation *State Profile,* June 30, 2007. Utah banks' aggregate tier 1 capital was 12.01 percent; the national average is about 10 percent. Tier 1 capital is the sum of common stockholders' equity, noncumulative perpetual preferred stock (including any related surplus), and minority interests in consolidated subsidiaries, minus ineligible intangible assets. The Core Capital (Leverage) ratio is Tier 1 Capital divided by adjusted average assets, as calculated in accordance with the FDIC's Statement of Policy on Risk-Based Capital. Utah banks' return on assets was 2.14 percent; the national average was about 1 percent.

[5] The collapse in 2002 of a prominent owner of an ILC, Conseco, for business reasons unrelated to the ILC, did not adversely affect its insured ILC. CRS Report RL32767, Industrial Loan Companies/Banks and the Separation of Banking and Commerce: Legislative and Regulatory Perspectives, Jan. 3, 2007, p. CRS-8.

SEC's Holding Company Supervision Program

The SEC established its CSE framework, in part, to allow major securities firms doing business in the European Union ("EU") to comply with the requirement of the EU's "Financial Conglomerates Directive." That Directive requires that non-EU firms doing business in Europe demonstrate that they are subject to a form of consolidated supervision by their home regulator that is "equivalent" to that required of their European counterparts. A firm failing to meet that test would lose its right to operate in the European marketplace – an unacceptable outcome for firms that derive significant revenues from Europe.

As a result, in 2004 the SEC introduced a voluntary consolidated supervision regime available to certain U.S. investment banks that were not regulated by the Federal Reserve as bank holding companies.[6] (Appendix A of this statement includes a detailed description of the SEC's Consolidated Supervised Entity oversight regime).[7] While the SEC traditionally focused on compliance with the securities laws by a firm's broker-dealer, the CSE framework extends supervision to the broker-dealer's holding company and affiliates, with particular attention to capital adequacy and risk-management practices. The option to be regulated as a CSE is available only to certain highly capitalized companies; essentially, the primary broker-dealer of each CSE must maintain tentative net capital of $5 billion and submit to a number of conditions with respect to the holding company and its affiliates.[8]

The SEC has examined the five CSEs (with a focus on the unregulated material affiliates) and concluded that the firms have generally well developed internal risk management controls and are compliant with the CSE rule. The SEC will continue regular examinations, and expects "practices will continue to evolve, with CSEs remaining among the leaders in industry risk management standards."[9]

SEC Commissioner Annette Nazareth has noted that the SEC's capacity to look globally at broker-dealer holding companies has been "dramatically expanded" as a

[6] Rel. No. 34-49830 (June 8, 2004), 69 Fed. Reg. 34428 (June 21, 2004).

[7] See also Hearings before the House Subcommittee on Financial Institutions and Consumer Credit, September 14, 2006.

[8] Including, but not limited to: computing capital consistent with the CSE Rule, a group-wide internal risk management control system, group-wide procedures to detect and prevent money laundering and terrorist financing, SEC examinations, providing financial and operational information, making examinations of other regulators available to the SEC, and acknowledging that the SEC can impose additional conditions under certain circumstances.

[9] Speech by Mary Ann Gadziala, Associate Director, Office of Compliance and Examinations, SEC, before the Annual Regulatory Examination and Compliance Seminar, Institute of International Bankers, New York, NY, October 31, 2006. Available at: http://www.sec.gov/news/speech/2006/spch103106mag.htm.

result of the CSE program. The CSE approach is "similar to that applied by the banking regulators to their most complex holding companies. This convergence of approaches, spanning multiple regulatory jurisdictions and national boundaries, has been well received by the regulated entities and bodes well for greater convergence of approaches in the future."[10]

The Government Accountability Office's ("GAO") report on CSEs found that "the Federal Reserve, OTS, and SEC were generally meeting criteria for comprehensive, consolidated supervision."[11] Similarly, SEC Chairman Christopher Cox, responding to the GAO report, wrote that, "I am gratified that the GAO's report highlights many broad similarities between the Commission's CSE program and the Federal Reserve's oversight of bank holding companies, which is the obvious model for a program of this type. I am also pleased that the report recognizes certain differences between investment banks and commercial banks, and that these should be reflected in the holding company supervision provided to each type of institution."[12]

SIFMA agrees that the CSE regime is robust and comprehensive. Importantly, the SEC's CSE oversight, like the Federal Reserve's oversight of bank holding companies, meets the European Union's equivalency standard. Similarly, the standards used by the SEC for purposes of consolidated regulation closely parallel the standards used by the Federal Reserve to assess whether a foreign regulatory regime qualifies as consolidated regulation for a foreign bank operating in the United States.[13] As such, industrial bank owners that are regulated as consolidated supervised entities should not be subject to any new industrial bank holding company oversight.

This designation is critically important to the operations of many of the largest securities firms based in the United States. Failure to recognize the SEC as a consolidated regulator would diminish the agency's standing as a global regulator, particularly when it has already been recognized as such by other international regulators. In turn, the direct damage to the international operations of U.S.-based securities firms would be significant and long-lasting. As stated previously, firms would also be subject to duplicative and unnecessary holding company oversight by both the SEC and the FDIC.[14]

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[10] Speech by SEC Commissioner Annette L. Nazareth before the NABE 2006 Washington Economic Policy Conference, March 13, 2006, p. 2, Available at http://www.sec.gov/news/speech/spch031306aln_nabe.htm

[11] GAO Report 07-154, "Financial Market Regulation: Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration," U.S. Government Accountability Office, March 2007, p. 5.

[12] GAO Report 07-154, p. 77.

[13] 12 C.F.R. § 211.24(c)(ii).

[14] The SEC recognizes the importance of this designation as well. "The [CSE] rule amendments also respond to international developments. Affiliates of certain U.S. broker-dealers that conduct business in the European Union ("EU") have stated that they must demonstrate that they are subject to consolidated

Comprehensive Review of the Financial Services Regulatory Structure Needed

Technological advances, shifting demographic trends, new forms of competition, and market innovations have transformed the financial services landscape to the benefit of investors, issuers, and the industry. Over the last two decades, capital markets and the financial services industry have become truly global, integrated and interconnected. In recognition of that trend, many other industrialized countries – the United Kingdom, Germany, Japan, the Netherlands, and Australia, for example – have consolidated their financial regulatory structures to better compete in today's global financial marketplace. The United States, however, has not changed its regulatory structure substantially.

As capital markets and financial products continue to evolve, so too must our nation's regulatory system. The United States needs a regulatory regime that is capable of keeping pace with rapid globalization, technological transformations, and dynamic market changes. That is why SIFMA's new Board of Directors unanimously agreed that SIFMA should develop a long-term strategy of seeking to harmonize and rationalize financial services regulation. We have begun that process, and note that the U.S. Treasury and other financial services groups have similar projects underway. We look forward to working with all interested parties – financial market participants, regulators and legislators – to ensure a modern, innovative, and globally responsive regulatory structure.

Conclusion

Industrial banks allow SIFMA member firms to provide much-needed banking services to their customers while posing no unusual safety and soundness risk. The industrial bank industry – comprised principally of deposits in banks operated by SIFMA member firms – has developed into one of the strongest and safest group of banks that ever existed. The current model for regulation of the holding companies and affiliates has been successful.

We believe strongly that SIFMA members that own industrial banks and are subject to consolidated regulation by the SEC should not be subject to additional holding company oversight. The SEC is recognized worldwide as a consolidated regulator, and its regulatory requirements and procedures were carefully designed to comply with all standards for effective consolidated regulation in the United States and abroad. That stature should be recognized in order to ensure global securities firms are not damaged inadvertently.

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supervision at the ultimate holding company level that is "equivalent" to EU consolidated supervision. Commission supervision incorporated into these rule amendments is intended to meet this standard. As a result, we believe these amendments will minimize duplicative regulatory burdens on firms that are active in the EU as well as in other jurisdictions that may have similar laws." (Introduction to the SEC's consolidated supervision rules: *Federal Register, Vol 69, No. 118, Monday, June 21, 2004.)*

Thank you for the opportunity to testify on this important issue. We look forward to working with you, Mr. Chairman, the Committee, Congress and regulators to ensure our financial services industry retains its preeminent status in the world.

Appendix A
SEC Holding Company Supervision Program Overview

(Source: http://www.sec.gov/divisions/marketreg/hcsupervision.htm)

Consolidated Supervised Entities ("CSEs")

The Commission supervises certain broker-dealer holding companies on a consolidated basis. In this capacity, Commission supervision extends beyond the registered broker-dealer to the unregulated affiliates of the broker-dealer and the holding company itself. In supervising these Consolidated Supervised Entities ("CSEs"), the Commission focuses on the financial and operational condition of the group. The aim is to reduce the likelihood that weakness in the holding company or an unregulated affiliate endangers a regulated entity or the broader financial system. Like other consolidated supervisors overseeing internationally active institutions, the Commission requires CSEs to compute capital adequacy measures consistent with the Basel Standard.

A broker-dealer becomes a CSE by applying for an exemption from the standard net capital rule, and the broker-dealer's ultimate holding company consenting to group-wide Commission supervision (if it does not already have a principal regulator).[1]

Under the alternative method for computing capital, contained in new Appendix E to Rule 15c3-1, firms with strong internal risk management practices may utilize the mathematical modeling methods they use to manage their own business risk, including value-at-risk ("VaR") models and scenario analysis to compute deductions from net capital for market risks and exposure modeling to compute deductions for credit risks related to over-the-counter derivatives. A broker-dealer calculating net capital adequacy using the alternative method must maintain tentative net capital[2] of at least $1 billion and net capital of at least $500 million. Moreover, if the tentative net capital of a broker-dealer using this alternative method falls below $5 billion, it must notify the Commission. The Commission then would consider whether to require the broker-dealer to take appropriate remedial action.

As noted above, the associated holding company must consent to a consolidated supervision regime if it does not already have a principal regulator. The ultimate holding company must execute a written undertaking in which it agrees, among other things, to do the following:

- Maintain and document an internal risk management control system for the affiliate group;
- Calculate a group-wide capital adequacy measure consistent with the international standards adopted by the Basel Committee on Banking Supervision ("Basel Standards");
- Consent to Commission examination of the books and records of the ultimate holding company and its affiliates, where those affiliates do not have principal regulators;
- Regularly report on the financial and operational condition of the holding company, and make available to the Commission information about the ultimate holding company or any of its material affiliates that is necessary to evaluate financial and operations risks within the ultimate holding company and its material affiliates; and
- Make available examination reports of principal regulators for those affiliates that are not subject to Commission examination.

The ultimate holding company must provide the Commission with monthly, quarterly, and annual reports. The reports must include specified consolidated financial and credit risk information, including a consolidated balance sheet and income statement audited by a registered public accounting firm; the capital adequacy measurement (statements of allowable capital and allowances for market, credit, and operational risk); the results of a review by the internal auditor of the risk management and control system of the ultimate holding company; and certain reports that the ultimate holding company regularly provides

to its senior management to assist in monitoring and managing risk. The ultimate holding company must make and keep current records of funding and liquidity stress tests, the basis for the determination of credit risk weights for each counterparty, the basis for the determination of internal credit ratings for each counterparty, and a record of the calculations of allowable capital and allowances for market, credit, and operational risk.

These reports will assist the Commission in monitoring the financial condition, the risk management control system, and the activities of the affiliate group to detect any events or trends that may adversely affect regulated entities or the broader financial system.

Holding Companies With Principal Regulators

To avoid duplicative or inconsistent regulation, a reduced set of requirements applies to holding companies with principal regulators associated with broker-dealers that seek to apply the alternative method of computing net capital. These holding companies must execute a written undertaking in which they agree, among other things, to do the following:

- Make available to the Commission information on controls relevant to the broker-dealer but resident in the holding company;
- Make available to the Commission information about the ultimate holding company or any of its material affiliates that is necessary to evaluate financial and operational risks within the ultimate holding company and its material affiliates; and
- Make available to the Commission capital adequacy measurements computed in accordance with the standards published by the Basel Committee on Banking Supervision and provided to the principal regulator.

CSE Supervisory Program

The Commission's supervisory program with respect to CSEs has four components:

- First, the SEC staff reviews the application prior to action by the Commission. As part of the review, the staff assesses the firm's financial position, the adequacy of the firm's internal risk management controls, and the mathematical models the firm will use for internal risk management and regulatory capital purposes. The staff also conducts on-site reviews to verify the accuracy of the information included in the application, and to assess the adequacy of the implementation of the firm's internal risk management policies and procedures.
- Second and following approval by the Commission, the SEC staff reviews monthly, quarterly, and annual filings containing financial, risk management, and operations data. These reports include consolidating financials (which show intercompany transactions that are eliminated during the preparation of consolidated financial statements) and risk reports substantially similar to those provided to the firm's senior managers. At least monthly, the holding company files a capital calculation made on a consolidated, group-wide basis consistent with the Basel Standards.
- Third, the SEC staff meets at least monthly with senior risk managers and financial controllers at the holding company level to review the packages of risk analytics prepared at the ultimate holding company level for the firm's senior management. The focus is on the performance of the risk measurement infrastructure, including statistical models; risk governance issues including modifications to and violations of risk limits; and the management of outsized risk exposures. In addition, there are quarterly meetings focused on financial results, the management of the firm's balance sheet, and, in particular, the liquidity of the balance sheet. Also on a quarterly basis, Commission staff meet with the internal auditor department to discuss implementation of the audit program as well as findings and reports that might bear on financial, operational, and risk controls. These regular discussions are augmented with focused work on risk management,

regulatory capital, and financial reporting issues of topical concern, which in some cases are pursued at several firms simultaneously.

- Fourth, the SEC staff conducts examinations of the books and records of the ultimate holding company, the registered broker-dealers (along with staff of the responsible self-regulatory organizations), and material affiliates that are not subject to supervision by a principal regulator. The examinations focus on the capital calculation and on the adequacy of implementation of the firm's documented internal risk management controls.

At present, five firms are subject to this regime: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley.

Holding Companies With Principal Regulators

The Commission's supervisory program with respect to a CSE with a principal regulator is distinct from that with respect to a CSE where the Commission has primary consolidated supervision responsibility for the holding company. The former relies significantly on the principal regulator to supervise the holding company, and thus focuses more narrowly on the broker-dealer. In general, the program in such cases consists of four parts.

- First, the SEC staff reviews the application prior to action by the Commission, as described above.
- Second and following approval, the SEC staff reviews monthly, quarterly, and annual filings containing financial, risk management, and operations data. These reports include consolidating financials (which show intercompany transactions that are eliminated during the preparation of consolidated financial statements) as well as the consolidated capital calculations filed with the principal regulator.
- Third, the SEC staff meets at least semi-annually with senior risk managers to review the packages of risk analytics prepared for the firm's senior management. The focus is on the overall performance of the risk measurement infrastructure, and especially the mathematical models used to compute deductions from net capital in the broker-dealer.
- Fourth, SEC and self-regulatory organization staff conduct examinations of the books and records of the registered broker-dealer. The examinations focus on the capital calculation and on the adequacy of implementation of the firm's documented internal risk management controls, some of which may be resident in the holding company.

This overview of the Commission's consolidated supervision program for broker-dealers and affiliates was prepared by and represents the views of the staff of the Division of Market Regulation, and does not constitute rules, regulations or statements of the Securities and Exchange Commission. For further information, contact Michael A. Macchiaroli, Associate Director, Matthew J. Eichner, Assistant Director, or Thomas K. McGowan, Assistant Director at (202) 551-5530.

[1] The definition of principal regulator contained in the rules encompasses, inter alia, the Federal Reserve and foreign supervisory regimes recognized by the Board of Governors of the Federal Reserve System ("Federal Reserve").

[2] "Tentative net capital" is defined in the CSE rules as net capital before deductions for market and credit risk.

"EXAMINING THE REGULATION AND SUPERVISION OF INDUSTRIAL LOAN COMPANIES": HEARING BEFORE THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, UNITED STATES SENATE
October 4, 2007

WRITTEN TESTIMONY OF ARTHUR E. WILMARTH, JR.
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Introduction

Thank you for inviting me to participate in this important hearing. My testimony will address three major policy questions related to acquisitions of industrial loan companies (ILCs) by commercial organizations.[1] First, does commercial ownership of ILCs conflict with a general U.S. policy of separating banking and commerce? Second, do commercially-owned ILCs present risks to the U.S. financial system and the broader economy that are greater than the risks posed by financial holding companies? Third, does the FDIC have adequate supervisory powers to control the potential risks created by commercially-owned ILCs, despite the FDIC's lack of consolidated supervisory authority over the commercial parent companies?[2]

The FDIC has imposed a temporary moratorium on acquisitions of ILCs by commercial firms. That moratorium is scheduled to expire on January 31, 2008.[3] The FDIC issued its moratorium after more than a dozen large commercial organizations –

[1] This testimony is adapted from the following article, which was published earlier this year: Arthur E. Wilmarth, Jr., "Wal-Mart and the Separation of Banking and Commerce," 39 *Connecticut Law Review* 1539-1622 (2007). I have submitted that article for inclusion in the record of this hearing.
[2] The policy questions addressed in my testimony were highlighted by the Federal Deposit Insurance Corporation (FDIC) earlier this year, when it invited Congress to consider whether to adopt legislation that would prohibit further acquisitions of ILCs by commercial firms. The FDIC imposed a moratorium on such acquisitions in July 2006 and extended that moratorium for an additional year on January 31, 2007. *See* Fed. Deposit Ins. Corp., "Moratorium on Certain Industrial Bank Applications and Notices: Limited Extension of Moratorium," 72 Fed. Reg. 5290 (Feb. 5, 2007) [hereinafter FDIC Moratorium Extension Notice], at 5291-93 (discussing policy issues raised by commercially-owned ILCs).
[3] *See id.* at 5290.

including Wal-Mart and Home Depot – filed applications to acquire ILCs.[4] The FDIC held three days of public hearings in April 2006 and heard testimony from nearly seventy witnesses, most of whom opposed acquisitions of ILCs by commercial firms. The FDIC also received more than 13,800 written comments on Wal-Mart's application, with the great majority opposing that application.[5]

On July 28, 2006, the FDIC placed a six-month moratorium on the processing of Wal-Mart's application and other applications by ILCs for deposit insurance.[6] A few weeks later, the FDIC issued a request for public comment on policy issues related to acquisitions of ILCs.[7] As the FDIC noted, the federal Bank Holding Company Act (BHC Act)[8] generally prohibits commercial firms from owning FDIC-insured "banks."[9] However, the BHC Act exempts an ILC from the definition of "bank," and thereby permits a commercial firm to own an ILC, if the ILC satisfies two criteria.[10] First, the ILC must be chartered in a state that, on March 5, 1987, had in effect or under

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[4] On March 16, 2007, Wal-Mart withdrew its application to acquire an FDIC-insured ILC that would be chartered by the State of Utah. Wal-Mart apparently withdrew its application because it concluded that widespread opposition to its application increased the likelihood that Congress would pass legislation to prohibit further acquisitions of ILCs by commercial firms. However, in a subsequent interview, Wal-Mart's president, H. Lee Scott, Jr., indicated that Wal-Mart has not given up its idea of acquiring an ILC. In addition, Home Depot's application to acquire EnerBank, a Utah-chartered ILC, remains pending before the FDIC. *See* Wilmarth, supra note 1, at 1541 n.*, 1595-96 (discussing Wal-Mart's decision to withdraw its application and Home Depot's pending application); Joe Adler, "In Brief: Banking Still on Wal-Mart's Agenda," *American Banker*, Mar. 29, 2007, at 20 (quoting interview on Fox News in which Mr. Scott said that "[w]e are looking at how we can get another bite of that apple," and replied, "Oh, no," when asked whether the possibility of acquiring an ILC was a "dead issue" for Wal-Mart).
[5] Wilmarth, supra note 1, at 1545-46.
[6] Fed. Deposit Ins. Corp., "Moratorium on Certain Industrial Loan Company Applications and Notices," 71 Fed. Reg. 43482 (Aug. 1, 2006) [hereinafter FDIC Moratorium Notice].
[7] Fed. Deposit Ins. Corp., "Industrial Loan Companies and Industrial Banks: Notice and Request for Comment," 71 Fed. Reg. 49456 (2006) [hereinafter FDIC Request for Comment].
[8] 12 U.S.C. §§ 1841-50.
[9] *See* FDIC Request for Comment, supra note 7, at 49458; U.S. General Accountability Office, "Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority," GAO-05-621, Sept. 2005 [hereinafter GAO-ILC Report], at 15, 65-67; Wilmarth, supra note 1, at 1566-70.
[10] 12 U.S.C. § 1841(c)(2)(H). *See* Wilmarth, supra note 1, at 1570-73 (discussing exemption for ILCs).

consideration a law requiring ILCs to obtain deposit insurance.[11] ILCs currently operate in seven states – California, Colorado, Hawaii, Indiana, Minnesota, Nevada and Utah – that authorize the chartering of FDIC-insured ILCs.[12] Second, the ILC must either have assets of less than $100 million or must refrain from accepting demand deposits (i.e., checking accounts payable on demand).[13]

Thus, ILCs with assets of more than $100 million may not offer demand deposits, but they can offer negotiable order of withdrawal (NOW) accounts to individuals and nonprofit organizations.[14] NOW accounts are functionally equivalent to interest-bearing checking accounts.[15] Accordingly, ILCs of all sizes can offer deposit accounts with check-writing features to all of their customers except for-profit businesses.[16] ILCs chartered under Utah law may use the title "bank" in their name and may exercise powers comparable to those of a state-chartered commercial bank, including the acceptance of deposits (except for demand deposits) and the making of consumer and commercial loans.[17]

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[11] *Id.* § 1841(c)(2)(H)(i).

[12] *See* FDIC Moratorium Notice, supra note 6, at 43482; Statement of Douglas A. Jones, Acting General Counsel of the FDIC, on "Industrial Loan Companies: A Review of Charter, Ownership and Supervision Issues," before the House Committee on Financial Services, July 12, 2006, at 2 (available at www.fdic.gov/news/news/speeches/chairman/spjul1107.html).

[13] 12 U.S.C. § 1841(c)(2)(H)(i) (I), (II). An ILC is also exempt from treatment as a "bank" under the BHC Act if it has not undergone a change of control since August 10, 1987, or if it does not engage, either directly, indirectly or through an affiliate, in any activity in which it was not engaged as of March 5, 1987. *Id.* § 1841(c)(2)(H)(i)(III), (ii). According to the FDIC, only twelve ILCs that are currently in operation were insured by the FDIC prior to August 10, 1987. Thus, only a small number of ILCs could potentially rely on these grandfathered authorities. *See* Statement of Douglas A. Jones, supra note 12, at 11-14 (Attach. 1).

[14] 12 U.S.C. § 1832; *see* GAO-ILC Report, supra note 9, at 23-24..

[15] Wilmarth, supra note 1, at 1550.

[16] *See* GAO-ILC Report, supra note 9, at 6 & n.5.

[17] *See id.* at 21-22, 24-25; Fed. Deposit Ins. Corp., Industrial Bank Subsidiaries of Financial Companies: Notice of proposed rulemaking, 72 Fed. Reg. 5217 (2007) [hereinaflter FDIC Proposed Rule on Consolidated Supervision], at 5221 n.32 (stating that "Utah industrial banks have essentially the same powers as Utah commercial banks except that industrial banks have more limited securities powers and less specific investment authority than commercial banks").

In addition, the Federal Deposit Insurance Act (FDI Act)[18] grants to ILCs the same powers and privileges that it provides to other FDIC-insured state banks.[19] For example, an ILC may "export" the interest rates permitted by the state in which it is "located" when the ILC makes loans to borrowers residing in other states.[20] An ILC may also establish interstate branches based on the same terms that apply to other FDIC-insured state banks that are chartered by the ILC's home state.[21] Under current law, for example, a Utah-chartered ILC can establish interstate de novo branches in thirty-four states.[22] In addition, a Utah ILC could operate branches throughout the nation if it is willing to acquire (and merge with) banks in the sixteen states where it cannot open de novo branches.[23]

In sum, under applicable state and federal laws, a commercially-owned ILC can conduct a nationwide banking business as long as it refrains from accepting demand checking accounts and thereby maintains its exemption from treatment as a "bank" under the BHC Act. At the end of 2006, fifty-eight ILCs were in operation, including forty-five institutions chartered by Utah and California and thirteen chartered by Colorado, Hawaii, Indiana, Minnesota and Nevada. Commercial firms owned fifteen of those ILCs.[24]

The FDIC received more than 12,600 written submissions in response to its request for comment on policy issues related to acquisitions of ILCs. Over eighty percent

[18] 12 U.S.C. §§ 1811-35a.

[19] Under the FDI Act, a state-chartered ILC that is engaged in the business of accepting deposits other than trust funds is considered to be a "State bank." 12 U.S.C. § 1813(a)(2).

[20] *See* 12 U.S.C. § 1831d; GAO-ILC Report, supra note 9, at 21-22.

[21] *See* 12 U.S.C. §§ 1828(d)(4) & 1831u; GAO-ILC Report, supra note 9, at 78-79.

[22] Currently, FDIC-insured banks may establish interstate de novo branches in seventeen states that permit banks from any state to open such branches. In addition, banks headquartered in Utah can establish interstate de novo branches in seventeen additional states that have branching laws that are reciprocal with Utah's branching statute. GAO-ILC Report, supra note 9, at 78.

[23] *See* 12 U.S.C. § 1831u.

[24] FDIC Moratorium Extension Notice, supra note 2, at 5291. California and Colorado have enacted laws barring commercial firms from acquiring ILCs chartered in those states. Wilmarth, supra note 1, at 1547. Consequently, Utah has become the primary focus for commercial firms seeking to acquire ILCs.

of those submissions opposed any further acquisitions of ILCs by commercial firms. In addition, more than a hundred members of Congress sent a letter to the FDIC on December 7, 2006, requesting that the FDIC extend its moratorium so that Congress could act on legislation to prohibit commercial firms from acquiring additional ILCs.[25]

On January 31, 2007, the FDIC extended its moratorium on acquisitions of ILCs by commercial firms for an additional year. The FDIC extended the moratorium because it concluded that acquisitions of ILCs by commercial firms raised special policy issues that warranted consideration by Congress. The FDIC also stated that it had "continuing concerns about commercial ownership of ILCs," because "the current supervisory process and infrastructure may not produce the safeguards that the FDIC believes could be helpful in identifying and avoiding or controlling, on a consolidated basis, the safety and soundness risks and the risks to the Deposit Insurance Fund that may result from that kind of company ownership model."[26]

In its moratorium extension notice, the FDIC identified the following major policy questions: (i) whether commercial ownership of ILCs produces a mixing of banking and commerce that is contrary to established U.S. policy, (ii) whether commercial ownership of ILCs creates undue risks for the U.S. financial system and the broader economy, and (iii) whether the FDIC's has adequate supervisory powers to control such risks, despite the FDIC's lack of consolidated supervisory authority over the commercial parent companies of ILCs.[27] Those three questions are addressed in Parts 1, 2 and 3 of the "Policy Analysis" section of my testimony.

[25] FDIC Moratorium Extension Notice, supra note 2, at 5292-93.
[26] *Id.*
[27] *Id.* at 5292-93.

Part 1 summarizes the history of federal and state legislation regarding the authority of banks to engage in commercial activities and the ability of commercial firms to own banks. Since our Republic's founding, banks have frequently tried to expand their activities into nonfinancial areas, and commercial firms have often attempted to control banks. However, federal and state legislators have generally sought to separate banks from commercial businesses. Indeed, legislators have repeatedly imposed legal restraints on bank powers and have prohibited bank affiliations with commercial firms when it appeared that either (i) the involvement of banks in commerce threatened their safety and soundness, or (ii) commercial firms were acquiring significant numbers of banks. The policy of separating banking and commerce has gained strength during the past half-century. On four occasions since 1956, Congress has adopted anti-affiliation laws when it realized that commercial firms were making widespread acquisitions of banks or other FDIC-insured depository institutions. ILCs represent the only significant exception to the general policy that prohibits acquisitions of FDIC-insured depository institutions by commercial firms.

Part 2 discusses three reasons why further acquisitions of ILCs by commercial firms are likely to create serious risks for our nation's financial system and general economy. First, the ownership of ILCs by large commercial firms will spread federal safety net subsidies to the commercial sector of the economy. Second, as shown by the financial history of the United States and other nations, commercially-owned ILCs face conflicts of interest that encourage them to make loans and investments to benefit their commercial affiliates. In combination, the extension of safety net subsidies to commercial firms and preferential lending by commercially-owned ILCs will (i) threaten

the solvency of the deposit insurance system and (ii) create a competitive imbalance between commercial firms that own ILCs and those that do not. Third, problems arising at commercial owners of ILCs are likely to create public concerns about the soundness of the ILCs themselves. Commercially-owned ILCs will therefore be subject to contagious losses of confidence, producing a greater likelihood of federal bailouts of their commercial owners.

As explained in Part 3, the FDIC currently does not have authority to exercise consolidated supervision over commercial firms that control ILCs. In addition, any decision by Congress to designate the FDIC as consolidated regulator of such firms would have at least four adverse effects. First, the FDIC lacks the experience or the specialized expertise to identify and control the risks created by commercial owners of ILCs. Second, the FDIC's designation as consolidated supervisor would lead market participants to expect that the federal safety net would be available to support commercial parent companies of ILCs. Third, attempts by the FDIC to control the activities of commercial affiliates of ILCs would significantly increase the amount of governmental regulation of our general economy and would undermine the effectiveness of market-driven incentives. Fourth, large commercial owners of ILCs are likely to enjoy substantial political influence, which they could use to extract costly subsidies or forbearance measures from both Congress and federal bank regulators.

Policy Analysis

1. Commercial Ownership of ILCs Is Contrary to Our General Policy of Separating Banking and Commerce

Economists and legal scholars have long debated whether the United States has followed a general policy of separating banking institutions from commercial

enterprises.[28] There have been times when banks invested in, or formed affiliations with, commercial enterprises. Indeed, failures of depository institutions involved with commercial activities triggered serious financial crises on several occasions. Each crisis led to legislation that imposed limitations on bank powers and affiliations in order to separate banks from general commercial activities. Congress also enacted laws on several occasions in order to close legal "loopholes" that allowed commercial firms to acquire significant numbers of FDIC-insured depository institutions. Thus, the clear trend in U.S. banking policy has been to separate banking from commerce, a trend that has grown stronger over time.

For example, the charters granted by the Pennsylvania legislature to the Bank of North America in 1787, and by Congress to the First and Second Banks of the United States in 1791 and 1816, barred those banks from engaging in commercial enterprises. The limitations contained in these early bank charters show that legislators were concerned about separating banking from commerce during the Republic's first three decades.[29] During the mid-19th century, state legislatures adopted "free banking" statutes that prohibited banks from engaging in commercial activities, and Congress followed the same approach in the National Bank Act of 1864. Those statutory constraints reflected a legislative reaction against the severe economic crisis of the early 1840s, which was precipitated by (i) the collapse of the Bank of the United States of Philadelphia and Morris Canal and Banking Company, following their aggressive expansion into commercial activities, and (ii) the failures of a number of state-chartered banks that

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[28] *See generally* Christine E. Blair, "The Future of Banking in America: The Mixing of Banking and Commerce," 16 *FDIC Banking Review* Nos. 3 & 4, at 97 (2004) (providing overview of debate).
[29] Wilmarth, supra note 1, at 1554-55.

financed or invested in real estate development, public works projects and other commercial ventures.[30]

The failures of several large financial-commercial conglomerates during 1930-33 – including Caldwell and Company, Bank of United States and the two largest Detroit banks – helped to persuade Congress to adopt the Banking Act of 1933 (1933 Act). The 1933 Act imposed significant restrictions on the activities and affiliations of banks. Sections 5(c) and 16 of the 1933 Act generally prohibited banks from making equity investments in nonbank corporations (except for authorized subsidiaries).[31] Additionally, he 1933 Act imposed strict limits on financial transactions between FRS member banks and their affiliates by adding a new Section 23A to the Federal Reserve Act.[32] Congress also authorized bank regulators to examine affiliates to evaluate their impact on the affairs of regulated banks.[33]

In response to the thrift debacle of the 1980s – including the failures of Lincoln Savings and other large thrift institutions that were heavily involved in real estate development and other commercial enterprises – Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).[34] Among other things, FIRREA prohibited state-chartered thrifts from engaging as principal or investing

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[30] *See* Wilmarth, supra note 1, at 1554-58.
[31] 12 U.S.C. §§ 335, 24 (Seventh). The 1933 Act's restrictions on equity investments originally applied only to national banks and state banks that were members of the Federal Reserve System (FRS). However, similar restrictions were applied to FDIC-insured state nonmember banks in 1991. Wilmarth, supra note 1, at 1564,
[32] Section 23A places strict limits on the amount and terms of "covered transactions" – including extensions of credit and purchases of assets or securities – between a bank and its affiliates. 12 U.S.C. § 371a. Congress subsequently extended the provisions of Section 23A to reach FDIC-insured state nonmember banks. Wilmarth, supra note 1, at 1565. In 1987, Congress adopted Section 23B of the Federal Reserve Act, which imposes additional requirements and restrictions on transactions between banks and their affiliates. 12 U.S.C. § 371b; Wilmarth, supra note 1, at 1571.
[33] 12 U.S.C. §§ 338, 481. In 1966, Congress gave the FDIC similar authority to examine affiliates of FDIC-insured nonmember banks. Wilmarth, supra note 1, at 1565.
[34] Wilmarth, supra note 1, at 1573-79.

in activities that were not permissible for federal savings associations. After a wave of bank failures occurred in the late 1980s, Congress imposed similar limitations on the powers of state-chartered banks in 1991.[35] In addition, Congress required thrifts to comply with the restrictions on affiliate transactions contained in Section 23A and Section 23B of the Federal Reserve Act.[36] Congress also barred thrifts from making any loans or other extensions of credit to affiliates engaged in activities that were not permissible for bank holding companies under 12 U.S.C. § 1843(c).[37]

On four occasions since 1950, Congress has enacted anti-affiliation laws when it realized that commercial firms were making widespread acquisitions of banks or other FDIC-insured depository institutions. When Transamerica and other commercial firms purchased numerous banks during the 1950s, Congress responded in 1956 by adopting the BHC Act, which prohibited multibank holding companies from engaging in activities that were not "closely related to banking."[38] When commercial conglomerates established a large number of one-bank holding companies in the late 1960s, Congress responded in 1970 by extending the BHC Act to reach those holding companies.[39] After commercial firms purchased dozens of FDIC-insured "nonbank banks" during the 1980s, Congress stopped the nonbank bank movement by adopting the Competitive Equality Banking Act of 1987 (CEBA).[40] After commercial firms acquired a substantial number of FDIC-insured thrift institutions in the 1990s, Congress barred further commercial acquisitions of thrifts by enacting the Gramm-Leach-Bliley Act of 1999 (GLBA).[41] On

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[35] Wilmarth, supra note 1, at 1580 (discussing 12 U.S.C. § 1831a).
[36] *Id.* at 1579 (discussing 12 U.S.C. § 1468(a)).
[37] *Id.* (discussing 12 U.S.C. § 1468(a)(1)(A)).
[38] *Id* .at 1566-67.
[39] *Id.* at 1567-69.
[40] *Id.* at 1569-71
[41] *Id.* at 1584-86

all four occasions, Congress declared that it acted in order to maintain a separation between banking and commerce.

Thus, the policy of separating banking and commerce has gained strength over time and has operated with particular force since 1956. It is true that the Federal Reserve Board (FRB) could undermine that policy by adopting expansive interpretations of GLBA's provisions allowing financial holding companies to engage in merchant banking, "financial in nature" activities, or activities that are "incidental" or "complementary" to financial activities. However, in enacting GLBA, Congress instructed the FRB to approve such activities in a carefully limited manner that would "maintain the separation between banking and commerce."[42] Congress gave the FRB a veto power over the scope of merchant banking, "financial in nature" and "incidental" activities, and Congress gave the FRB sole authority to determine the scope of "complementary" activities. In assigning these gatekeeping roles to the FRB, Congress presumably intended that the FRB would perform those roles in a conservative manner based on the FRB's longstanding policy position against mixing banking and commerce.[43]

The one significant remaining exception to the congressional policy of separating banking and commerce is the provision of CEBA that allows commercial firms to acquire FDIC-insured ILCs.[44] The legislative history of CEBA does not explain why Congress

[42] *Id.* at 1582 n.254 (quoting H.R. Rep. No. 106-74, pt. 1, at 122 (1999)); *see also id.* at 1583 n.259 (quoting 145 Cong. Rec. S13788 (daily ed. Nov. 3, 1999) (remarks of Sen. Sarbanes), and 145 Cong. Rec. H11527 (daily ed. Nov. 4, 1999) (remarks of Rep. Leach)).

[43] *Id.* at 1582-84.

[44] *See id.* at 1550, 1572. CEBA also exempted limited-purpose trust companies and credit card banks from the definition of "bank" under the BHC Act and thereby permitted commercial firms to acquire such institutions. However, CEBA imposed stringent limitations that effectively prevent limited-purpose trust companies and credit card banks from engaging in a retail banking business or from making commercial loans. *See id.* at 1571.

decided to exempt ILCs from the BHC Act's prohibition on commercial ownership of FDIC-insured depository institutions.[45] However, former Senator Jake Garn of Utah, a co-sponsor of the ILC exemption, explained his personal view of that exemption when he testified during the FDIC's public hearings in April 2006 on Wal-Mart's application to acquire an ILC. Senator Garn declared that he would strongly oppose any attempt by Wal-Mart to "expand their application" to offer retail banking services at Wal-Mart stores, because "it was never my intent, as the author of this particular section, that any of these industrial banks be involved in retail operations. . . . I would be the most vociferous opponent of that because that was not my intent at the time CEBA was passed."[46]

Senator Garn's testimony indicates a congressional understanding in 1987 that ILCs would not be used as a platform for large commercial firms to offer full-service banking to consumers at the parent companies' retail outlets. In 1987, ILCs were small state-chartered institutions that had limited deposit-taking powers and engaged principally in making consumer loans to middle-income and lower-income individuals. Thirteen ILCs failed during 1982-84, and Utah imposed a moratorium on chartering new ILCs in 1987.[47] The total assets of all ILCs in 1987 were only $4.2 billion, and the

[45] The exemption for ILCs was contained in a managers' amendment, which was co-sponsored by Senators William Proxmire and Jake Garn and was approved during the Senate floor debates on CEBA. 133 Cong. Rec. S 3810, S 3813 (daily ed., Mar. 25, 1987) (remarks of Sen. Proxmire). Senators who discussed the ILC exemption and the conference committee report simply summarized the statutory terms of the ILC exemption and did not explain its underlying purpose or intended scope. *See id.* at S 3813 (remarks of Sen. Proxmire); *id.* at S 3957 (daily ed. Mar. 26, 1987) (colloquy between Sen. Inouye and Sen. Proxmire); H.R. Rep. No. 100-261, at 121 (1987) (Conf. Rep.), reprinted in 1987 U.S.C.C.A.N. 588, 592.
[46] Oral Testimony of Hon. Edwin J. "Jake" Garn, FDIC Hearings on Wal-Mart Application, April 10, 2006 (Panel 8), at 8, 12.
[47] Testimony of FRB General Counsel Scott G. Alvarez before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services, July 12, 2006 (available at federalreserve.gov/boarddocs/textimony/2006/20060712/default.htm), at 5; Bill McConnell, Utah to End Freeze on Charters for Industrial Loan Companies, *American Banker*, April 3, 1997, at 3 (stating that Utah imposed a "freeze" on new ILC charters in 1987, "following a wave of failures"); Barry Stavro, As Good as Their Word, Forbes, Feb. 25, 1985, at 52.

largest ILC had less than $420 million of assets.[48] In 1993, a Congressional Research Service report stated that ILCs played only a "minor" role in the U.S. financial system.[49]

However, ILCs have expanded rapidly in recent years, due in part to the liberalization of state laws governing ILCs. For example, Utah amended its laws in 1997 to give ILCs virtual parity with state-chartered commercial banks (except for the ability to offer demand deposits).[50] In addition, GLBA encouraged commercial firms to seek ILC charters, because GLBA barred commercial firms from making any further acquisitions of thrift institutions. During 1999-2006, total assets held by ILCs grew from $44 billion to $177 billion. Currently, the largest ILC (owned by Merrill Lynch) holds more than $60 billion of assets, and commercial firms own fifteen ILCs.[51]

Thus, the ILC industry has changed dramatically since Congress enacted CEBA in 1987. The FDIC recently stated that the business plans prepared by Home Depot and other proposed commercial owners of ILCs "differ substantially from the consumer lending focus of the original industrial banks."[52] When CEBA was passed, Congress evidently did not appreciate the potential threat that the ILC exemption would pose to the policy of separating banking and commerce.

Congress' lack of awareness of the potential impact of the ILC exemption becomes clearer when one considers that CEBA closed the "nonbank bank loophole." CEBA was expressly designed to prevent retailers and other commercial firms from

[48] FDIC Moratorium Notice, supra note 6, at 43482.
[49] William Jackson, "Mixing Banking and Commerce Using Federal Deposit Insurance: Industrial Banks and Nonbank Banks," *Congressional Research Service Report* 93-769 E, Aug. 26, 1993, at n.7 and accompanying text (stating that ILCs had only $7 billion of assets at the end of 1992, while U.S. commercial banks and trust companies held $3.5 trillion of assets).
[50] Utah liberalized its ILC statutes and authorized the chartering of new ILCs in 1997. *See* McConnell, supra note 47. For discussions of the Utah laws governing ILCs, *see* GAO-ILC Report, supra note 9, at 21-22, 24-25; FDIC Proposed Rule on Consolidated Supervision, supra note 17, at 5221 n.32.
[51] Wilmarth, supra note 1, at 1573.
[52] FDIC Moratorium Extension Notice, supra note 2, at 5291.

continuing to acquire FDIC-insured "nonbank banks."[53] The Senate committee report on CEBA declared that "[n]onbank banks undermine the principle of separating banking and commerce, a policy that has long been the keystone of our banking system. . . . The separation of banking and commerce helps ensure that banks allocate credit impartially, and without conflicts of interest."[54] It is highly improbable that Congress decided to close the "nonbank bank loophole" in 1987 for the specific purpose of preserving the separation of banking and commerce but, at the same time, inserted the ILC exemption with the conscious goal of undermining the same policy.

2. Commercially-Owned ILCs Pose Significant Risks to the U.S. Financial System and General Economy

For at least three reasons, continued acquisitions of ILCs by commercial firms are likely to create serious risks for our nation's financial system and general economy. First, ownership of ILCs by large commercial firms is likely to spread the federal safety net and "too big to fail" (TBTF) subsidies from the financial sector to the commercial sector of the economy. The ability of commercial owners of ILCs to gain access to low-cost, FDIC-insured funds will increase the risks to the deposit insurance fund and will create competitive inequities between commercial firms that control ILCs and those that do not. Ownership of a large ILC by a giant commercial firm would place great pressure on federal regulators to provide financial support if either the ILC or its parent company was threatened with failure.

Second, commercially-owned ILCs are subject to conflicts of interest that encourage them to make loans and investments to benefit their commercial affiliates. As shown by the financial history of the United States and other nations, preferential

[53] Wilmarth, supra note 1, at 1569-71.
[54] S. Rep. No. 100-19, at 8, as reprinted in 1987 U.S.C.C.A.N. at 498.

transfers of funds from banks to commercial affiliates or their customers create significant risks for the deposit insurance fund and also increase the likelihood of a systemic economic crisis. In addition, such transfers provide commercial owners of ILCs with an unfair competitive advantage over firms that do not have bank affiliates.

Third, problems arising at commercial owners of ILCs are likely to create public concerns about the soundness of the ILCs. Commercially-owned ILCs will therefore be subject to contagious losses of confidence resulting from problems at their commercial parent companies. In turn, such losses of public confidence will produce a greater likelihood of TBTF bailouts.

a. Extension of the Federal Safety Net and TBTF Subsidies to Commercial Owners of ILCs

During the 1990s, scholars, regulators and lawyers debated whether the federal "safety net" for financial institutions provided a net subsidy to banks.[55] Those who denied the existence of a net subsidy argued that the costs of banking regulation exceeded the value of any safety net subsidy.[56] However, a more recent study concluded that safety net subsidies have increased since the mid-1990s and probably do provide a net subsidy to most banks.[57] Similarly, the General Accountability Office (GAO) stated in 2005 that the federal safety net "provides a subsidy to commercial banks and other depository institutions by allowing them to obtain low-cost funds," and by "shift[ing] part

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[55] The federal "safety net" for financial institutions consists of (i) federal deposit insurance, (ii) protection of uninsured depositors and other uninsured creditors of TBTF institutions, (iii) discount window advances provided by the FRB as "lender of last resort" (LOLR), and (iv) the FRB's guarantee of interbank payments made on Fedwire. *See* Joe Peek & James A. Wilcox, "The Fall and Rise of Banking Safety Net Subsidies," in *Too Big to Fail: Policies and Practices in Government Bailouts* (Benton E. Gup, ed. 2004), at 169, 179-83; John R. Walter, "Can a Safety Net Subsidy Be Contained?", 84 *Economic Quarterly* No. 1, Fed. Res. Bank of Rich., VA, at 1, 2 (1998).

[56] For helpful overviews of this debate, *see* Patricia A. McCoy, *Banking Law Manual* § 4.02 at 4-12 (2d ed. 2006); Peek & Wilcox, supra note 55, at 184-87.

[57] Peek & Wilcox, supra note 55, at 170, 187-90.

of the risk of bank failure from bank owners and their affiliates to the federal bank insurance fund and, if necessary, to taxpayers."[58]

During a systemic crisis, the safety net subsidy is likely to become very large because the federal government, in effect, provides "catastrophe insurance."[59] If the deposit insurance fund is inadequate to cover the cost of resolving failed banks, the federal government has shown a willingness to mobilize taxpayer funds to prevent a collapse of the financial system.[60] For example, during the thrift and banking crises of 1980-94, the deposit insurance funds for banks and thrifts spent $64 billion in resolving the failures of nearly 3,000 thrifts and banks. The thrift deposit insurance fund was wiped out, and Congress used $132 billion of taxpayer funds to cover the full cost of resolving thrift failures. The bank insurance fund was depleted to the point of insolvency, and Congress expanded the FDIC's line of credit at the Treasury from $5 billion to $30 billion.[61] Many other nations have similarly provided extensive assistance to banks and generous protection to bank depositors during systemic financial crises in the 1980s and 1990s.[62] Most recently, U.K. authorities announced a blanket guarantee of bank deposits and provided financial support to Northern Rock, a large mortgage lender,

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[58] GAO-ILC Report, supra note 9, at 71-72.
[59] Peek & Wilcox, supra note 55, at 180.
[60] *Id.* at 180-81.
[61] Resolving the failures of 1,300 thrifts required (i) $28 billion of funds from the FSLIC deposit insurance fund for thrifts and (ii) $132 of taxpayer funds. Resolving the failures of 1.600 banks required $36 billion from the FDIC's bank insurance fund, which left the fund effectively insolvent in 1991. At that point, Congress provided the FDIC with authority to borrow up to $30 billion from the Treasury (an authority that the FDIC ultimately did not have to use). *See* Wilmarth, supra note 1, at 1589 & n. 290.
[62] *See id.* at 1589, 1599-1606; Gary H. Stern & Ron J. Feldman, *Too Big to Fail: The Hazards of Bank Bailouts* 40, 75-77 (2004).

in order to stop a run by Northern Rock's depositors.[63] Thus, the subsidy provided by the federal safety net increases greatly in magnitude during a financial crisis.

Whether or not small banks enjoy a subsidy, many analysts believe that the safety net provides significant subsidies to large banks that are viewed as TBTF by the financial markets. For example, Countrywide recently faced a serious liquidity squeeze when the securitization and credit markets cut off funding for nonprime mortgage loans. Countrywide survived because it could call upon funding from (i) FDIC-insured deposits held by its federally-chartered thrift subsidiary, and (ii) advances from the Federal Home Loan Bank System. Additionally, some commentators believe that the FRB quietly encouraged large banks to provide emergency funding to Countrywide. In contrast, dozens of smaller, nondepository subprime lenders went out of business during the past year after they lost access to funding from the securitization and credit markets.[64]

Analysts have found that (i) TBTF banks – generally those with assets over $100 billion – pay interest rates on deposits that are significantly lower than the rates paid by nonbank companies of comparable size on short-term, uninsured debt, (ii) TBTF banks operate with significantly higher leverage (i.e., lower capital-to-asset ratios) than uninsured financial intermediaries such as commercial and consumer finance companies and life insurers, and (iii) banks achieve higher credit ratings and pay lower interest rates on their bonds as they grow in size to achieve TBTF status.[65] Indeed, the TBTF subsidy

[63] *See* Kate Burgess et al., "Week that shook the banking world," *Financial Times*, Sept. 22, 2007, at 3; Stanley Reed, "Subprime Tremors: Suddenly, a Bank Run in Britain," *Business Week*, Oct. 1, 2007, at 40.
[64] *See* Kate Berry, "Thrift Unit Buttresses Countrywide's Continuity," *American Banker*, Sept. 10, 2007, at 20; Maria Bartiromo, "The Mortgage Mess: The Heat on Countrywide," *Business Week*, Sept. 10, 2007, at 28; James R. Hagerty, "Countrywide Is to Cut 20% of Work Force," *Wall Street Journal*, Sept. 8, 2007, at B1; James R. Hagerty & Lingling Wei, "Countrywide Seeks Deposits to Fund Loans," *Wall Street Journal*, Sept. 19, 2007, at A4..
[65] *See, e.g.*, Stern & Feldman, supra note 62, at 30-39; Edward J. Kane, "Incentives for Banking Megamergers: What Motives Might Regulators Infer from Event-Study Evidence?", 32 *Journal of Money*,

has been an important motivating factor behind the rapid consolidation that has taken place in the U.S. banking industry over the past two decades.[66]

The existence of a subsidy for TBTF institutions is further indicated by the fact that no major U.S. bank has ever surrendered its bank charter and chosen to operate as a nonbank.[67] In contrast, large nonbanking companies have consistently sought to gain control of FDIC-insured depository institutions. Securities firms, life insurance companies and commercial firms acquired nonbank banks before the nonbank bank loophole was closed in 1987, and they also acquired thrifts before the unitary savings and loan holding company loophole was closed in 1999. Each of the four largest U.S. securities firms – Merrill Lynch, Morgan Stanley, Goldman Sachs and Lehman Brothers – owns a Utah-chartered ILC. Currently, thirty-three insurance companies own some type of bank, while fifteen commercial firms own ILCs. If the costs of bank regulation actually exceed the benefits provided by the federal safety net, it is very difficult to understand why no major bank has ever given up its charter, and why so many nonbanking companies have been so eager for so long to acquire a financial institution charter that will enable them to offer FDIC-insured deposits to their customers. In my

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Credit & Banking 671 (2000) [hereinafter Kane, "Megamerger Incentives"], at 673-74, 691-95; George Pennacchi, "Deposit insurance, bank regulation, and financial system risks," 53 *Journal of Monetary Economics* 1, 14-16 (2005); Donald P. Morgan & Kevin J. Stiroh, "Too Big to Fail after All These Years," Fed. Res. Bank of NY Staff Rep. No. 220, Sept. 2005 (available at http://ssrn.com/abstract=813967), *passim*; Maria F. Penas & Haluk Unal, "Gains in bank mergers: Evidence from the bond markets," 74 *Journal of Financial Economics* 149, 150-51, 155, 159, 161-62, 168, 170-71 (2004).

[66] *See ,e g.,* Stern & Feldman, supra note 62, at 32-33, 60-79; Gerald A. Hanweck & Bernard Shull, "The Bank Merger Movement: Efficiency, Stability and Competitive Policy Concerns," 44 *Antitrust Bulletin* 251, 273-79 (1999); Kane, "Megamerger Incentives," supra note 65, at 673-74. 683-95; Arthur E. Wilmarth, Jr., "The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks," 2002 *University of Illinois Law Review* 215, 300-12 (2002) [hereinafter Wilmarth, "Transformation"].

[67] Wilmarth, "Transformation," supra note 66, at 447 n.1033.

view, banks and nonbanking companies have indisputably proven the existence of a safety net subsidy – at least for large financial institutions – by voting with their feet.[68]

Merrill Lynch is a leading example of a nonbank financial institution that has reaped significant benefits from its access to the federal safety net. Merrill acquired a thrift institution and an ILC during the 1990s. In 2000, Merrill introduced a "sweep account" program in order to transfer its customers' cash balances from uninsured brokerage accounts into FDIC-insured deposits in its subsidiary depository institutions. By 2006, Merrill's banks held $80 billion in deposits, and Merrill used those deposits to fund $70 billion of commercial and consumer loans. Citigroup's Smith Barney brokerage unit and other major securities brokers have introduced similar sweep account programs to move customer cash balances into FDIC-insured deposits at their affiliated banks.[69]

A 2004 study estimated that sweep account programs created $350 billion of FDIC-insured deposits that otherwise would have been held in uninsured money market mutual funds (MMMFs) at brokerage firms.[70] Securities firms with bank affiliates have established these sweep programs because FDIC-insured deposits pay interest rates that are much lower, and earn spreads that are much higher, than the rates and spreads applicable to uninsured MMMFs.[71] A comment letter submitted by the Securities Industry Association (SIA) to the FDIC in 2006 confirms the significant benefits produced by sweep programs:

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[68] Wilmarth, supra note 1, at 1590-91.
[69] Pennacchi, supra note 65, at 15 & n.21; Wilmarth, supra note 1, at 1591.
[70] Pennacchi, supra note 65, at 15 (citing study by Crane and Krasner).
[71] *Id.* at 15-16; Wilmarth, "Transformation," supra note 66, at 448 & n.1035. Unlike bank deposits, which can be used to fund commercial and consumer loans, MMMFs may only invest in highly-rated securities with an average maturity of not more than 90 days. Timothy Q. Cook & Jeremy G. Duffield, "Money Market Mutual Funds and Other Short-Term Investment Pools," in *Instruments of the Money Market* (Fed. Res. Bank of Rich., VA, 7th ed. 1993), at 156, 165-67.

> Bank subsidiaries have added significant value and versatility to SIA member corporate groups, because SIA member owned banks hold idle funds swept from brokerage accounts [into] deposits. . . . This has provided a reliable and low cost source of deposits to fund traditional banking products and services offered to customers of the corporate group . . . . The most cost effective way to fund bank quality loans is with deposits.[72]

Many commentators believe that GLBA has extended TBTF protection to the nonbank affiliates of large financial conglomerates that control banks.[73] Owners of major commercial firms might reasonably expect that they, too, will receive TBTF treatment if they acquire ILCs and expand the assets of their ILCs as rapidly as Merrill has done.[74] If Wal-Mart, the world's largest retailer, and Home Depot, the second largest U.S. retailer, acquired ILCs and opened deposit-taking branches in many of their stores, they could probably match or improve on Merrill's deposit-taking performance.[75]

Given the immense size of both Wal-Mart and Home Depot, it seems inconceivable that federal regulators would allow either company to collapse if it owned a large FDIC-insured ILC. Wal-Mart accounts for eight percent of domestic retail sales and two percent of the gross domestic product. On several occasions since 1970, the federal government has intervened to save or reorganize a company or industry whose

[72] Letter to the FDIC, dated Oct. 10, 2006, from the Securities Industry Ass'n, at 3, Comment No. 71 in Comments on Industrial Loan Companies and Industrial Banks (available at www.fdic.gov/regulations/laws/federal/2006/06comilc.html) [hereinafter Comments to the FDIC on ILCs].

[73] Henry Kaufman, *On Money and Markets: A Wall Street Memoir* 209-10, 237-40 (2000); Stern & Feldman, supra note 62, at 70-77; Wilmarth, "Transformation," supra note 66, at 303-04, 446-50, 474-75.

[74] The Federal Reserve Board (FRB) has authority extend discount window loans to any nonbanking company "in unusual and exigent circumstances." 12 U.S.C. § 343. Section 343 would permit the FRB to provide financial support to any nonbanking firm whose survival is deemed necessary to maintain the stability of the financial markets. *See* Henry T.C. Hu, "Faith and Magic: Investor Beliefs and Government Neutrality," 78 *Texas Law Review* 777, 873-75 (2000); Wilmarth, "Transformation," supra note 66, at 304 & n.369.

[75] Wal-Mart operates some 3,300 stores in the United States and about 6,700 stores globally. During its 2006 fiscal year, Wal-Mart produced domestic sales of $326 billion and global sales of $349 billion, making it the largest retailer in the United States and the world. Home Depot operates more than 2,100 stores in the United States and generated total sales of $91 billion in 2006, making it the second largest U.S. retailer. Wilmarth, supra note 1, at 1592-93 n.309.

survival was deemed important to the national interest.[76] On at least four other occasions during that period, the FRB has taken action to maintain the stability of the financial markets after the failure of a major nonbanking firm.[77] Given those precedents, acquisitions of ILCs by Wal-Mart, Home Depot and other giant commercial firms will significantly increase the likelihood and potential costs of similar federal interventions in the future.

Based on the foregoing considerations, it seems clear that (i) large commercial owners of ILCs will obtain substantial financial benefits from the federal safety net, particularly in the form of low-cost deposits and implicit catastrophe insurance, and (ii) those commercial firms will have a significant funding advantage – and therefore an important competitive edge – over competitors that do not own ILCs.[78] Unless acquisitions of ILCs by commercial firms are prohibited, many large commercial entities will probably deem it essential to acquire ILCs in order to maintain competitive parity with those firms that already own ILCs. Thus, over time, acquisitions of ILCs by large commercial firms will almost certainly create serious distortions within the general economy.

b. Conflicts of Interest, Preferential Lending and Systemic Risk

i. Evidence from the United States

[76] *See id.* at 1593 n. 311 (discussing (i) federal support for the reorganization of railroads following Penn Central's bankruptcy in 1970, (ii) federal loan guarantees given to Lockheed in 1971 and Chrysler in 1980, and (iii) federal payments and loan guarantees provided to airlines after the terrorist attacks on September 11, 2001).

[77] *See id.* at 1592 n. 312 (citing the FRB's interventions to stabilize the financial markets following (i) the collapse of Penn Central in 1970, (ii) the Hunt Brothers' failed attempt to corner the silver market in 1980, (iii) the stock market crash in 1987, and (iv) the collapse of Long Term Capital Management (LTCM) in 1998).

[78] *See* GAO-ILC Report, supra note 9, at 71-72.

Acquisitions of ILCs by commercial firms create conflicts of interest that pose significant risks to the deposit insurance fund and increase the likelihood of a systemic economic crisis. As shown above, ILCs enjoy a significant funding advantage over nonbanking firms, due to their ability to attract FDIC-insured deposits at subsidized, below-market rates. Commercial owners of ILCs have powerful financial incentives to transfer this funding advantage by causing their ILCs to pay generous dividends and to make preferential loans to the parent companies and their commercial subsidiaries. The desire to draw on funds from a bank affiliate intensifies when the commercial parent or a commercial affiliate encounters financial problems. For example, when Caldwell and Company (a financial-commercial conglomerate that failed in 1930) and American Continental Company (the parent of Lincoln Savings) lost access to other sources of funds, they extracted large amounts of funds from their depository institution affiliates.[79] Similarly, Bank of United States failed in 1930 after it made large loans to support its securities and real estate affiliates.[80]

Commercial firms could also cause their ILCs to support their operations in other ways. For example, a parent company could cause its ILC to purchase doubtful customer receivables or other questionable assets, or it could insist that the ILC encourage its depositors and other customers to purchase the parent's securities. In the late 1980s, American Continental used the branches and employees of Lincoln Savings to promote

[79] Wilmarth, supra note 1, at 1560-61, 1576-78. Similarly, when Drexel Burnham was threatened with failure in early 1990, it made capital withdrawals from its regulated securities subsidiaries in excess of regulatory limits until the SEC intervened to prevent further capital transfers. Wilmarth, "Transformation," supra note 66, at 456 n.1058; *see also* Jonathan Brown, *The Separation of Banking and Commerce* (available at www.public-gis.org/reports/sbc.html), at 25 (quoting SEC chairman Richard Breeden's Senate testimony concerning Drexel Burnham's failure, in which Mr. Breeden acknowledged that the SEC did not fully appreciate the "risk that the broker-dealer's capital could be depleted in a desperate but fruitless attempt to pay the parent firm's unsecured creditors"). [Note: Mr. Brown's paper is undated, but evidently it was written in 1990. *See id.* at 34, 41.]

[80] Wilmarth, supra note 1, at 1561-62.

the sale of the American's uninsured subordinated notes to more than twenty thousand customers. Those customers suffered severe losses when Lincoln failed and American filed for bankruptcy.[81] Similarly, in the early 1970s, Beverly Hills Bancorp sold $12.5 million of commercial paper to more than two hundred customers of its subsidiary bank, Beverly Hills National Bank. After the parent company defaulted on the commercial paper, the customers sued the bank and forced it into conservatorship and liquidation.[82]

In addition, commercial firms may induce their ILCs to make preferential loans to suppliers of the parent company in order to gain concessions for the parent company.[83] Commercial firms can similarly use their ILCs to extend credit to customers to promote the sale of the parent's products.[84] For example, Volkswagen, Target and Toyota acquired Utah ILCs during 2002-04. The primary business of Volkswagen Bank and Toyota Financial Savings Bank is to make loans to consumers and businesses to finance purchases of automobiles produced by their parent companies. Similarly, Target Bank issues proprietary credit cards to business firms to facilitate their purchases of goods at Target stores.[85]

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[81] *Id.* at 1577-78.

[82] *Id.* at 1594-95, 1607.

[83] *See* Brown, supra note 79, at 5-6, 9, 12-13 (stating that, prior to the enactment of the 1970 amendments to the BHC Act, federal examiners discovered that a commercial bank controlled by Sears "had a heavy concentration of its commercial loans to firms that were Sears' suppliers," *id.* at 9); *see also* GAO-ILC Report, supra note 9, at 72.

[84] Brown, supra note 79, at 5-6, 12-13; *see also* GAO-ILC Report, supra note 9, at 72.

[85] Statement of Douglas H. Jones, supra note 12, at 3, 12-14 (attach. 1). A recent comment letter submitted to the FDIC by two ILC trade associations explained how an ILC can provide credit to customers of its parent company in compliance with Sections 23A and 23B. The comment letter stated that an ILC can lawfully make loans to its parent's customers as long as the parent either (i) buys the customer loans from the ILC without recourse, or (ii) maintains a cash deposit at the ILC equal to the amount of outstanding customer loans. *See* Letter to the FDIC, dated Oct. 10, 2006, from the Utah Ass'n of Financial Services and the Calif. Ass'n of Industiral Banks, at 12, 33-34, Comment No. 109 in Comments to the FDIC on ILCs, supra note 72. If the letter is correct, a commercial parent company can call upon its ILC to provide unlimited credit to the parent's customers as long as the parent company is willing to cover the credit risk associated with those loans. However, that arrangement provides relatively little comfort to the federal deposit insurance fund and to taxpayers, because excessive and unsound loans to customers could inflict crippling losses on the parent company. In turn, problems at the parent companiy of a financial institution

Home Depot has filed an application to acquire a Utah ILC called EnerBank. EnerBank's proposed business plan is to make installment loans to consumers who hire EnerBank-approved contractors for home improvement projects. Home Depot hopes that EnerBank's loans will encourage approved contractors to purchase materials for home improvement projects at Home Depot stores. Although Home Depot claims that contractors will not be compelled to buy their materials at Home Depot stores, contractors cannot participate in the program unless they are approved by EnerBank as "loan program sponsors." It certainly seems doubtful whether a contractor would retain its status as an approved EnerBank "sponsor" if it failed to buy a significant portion of its materials from Home Depot.[86]

Thus, the existing and proposed business plans of commercially-owned ILCs reflect a consistent strategy among commercial firms to promote the sale of their products by using the credit facilities of their captive ILCs. Advocates for commercial ownership of ILCs argue that "firewalls" established by laws restricting affiliate transactions and insider lending will prevent an ILC from making unsound loans or abusive transfers of funds to benefit its commercial affiliates.[87] As noted above, Sections 23A and 23B of the Federal Reserve Act impose quantitative limits and collateral requirements on affiliate transactions, prohibit bank purchases of low-quality assets from affiliates, and require affiliate transactions to be conducted on arms' length terms.[88] In addition, federal statutes and regulations impose strict conditions on loans made by any FDIC-insured

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are likely to undermine public confidence in the subsidiary institution. *See* Wilmarth, supra note 1, at 1606-13.

[86] Wilmarth, supra note 1, at 1595-96.

[87] *See, e.g.*, Blair, supra note 28, at 98-99, 103-04; Statement of Lawrence J. White, in FDIC Hearings on Wal-Mart Application, April 11, 2006 (Panel 3), at 4-11.

[88] 12 U.S.C. §§ 371a & 371b..

bank to its directors, executive officers and principal shareholders and their related interests.[89]

However, these firewalls have often been disregarded under circumstances of financial stress when the financial viability of a controlling shareholder or affiliate is threatened. A high percentage of thrift failures during the 1980 involved violations of rules governing affiliate transactions and insider lending.[90] Similarly, a 1994 GAO study found that unlawful insider lending and abusive affiliate transactions occurred at a significant proportion of 175 banks that failed during 1990-91.[91] United States National Bank of San Diego failed in 1973 after making massive loans to its controlling shareholder and his affiliates in violation of legal lending limits.[92] Hamilton National Bank failed in 1976 after its parent holding company violated Section 23A by forcing the bank to purchase large amounts of low-quality mortgages from the bank's mortgage banking affiliate.[93] During the 1987 stock market crash, Continental Illinois violated legal lending limits in order to prevent its options trading subsidiary from failing.[94]

Two large FDIC-insured ILCs have failed since 1999, resulting in losses to the deposit insurance fund of more than $100 million.[95] In each case, the corporate parent and the ILC operated in a unitary fashion that did not maintain any meaningful corporate separation, and the parent and the ILC engaged in transactions that violated Sections 23A

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[89] *See* McCoy, supra note 56, § 14.04[1][d] (discussing restrictions on loans to insiders under 12 U.S.C. §§ 375a, 375b, 1468(b) and 1828(j)(2) and the regulations adopted thereunder).
[90] Wilmarth, supra note 1, at 1575-77.
[91] Catharine M. Lemieux, "Conglomerates, Connected Lending and Prudential Standards: Lessons Learned," 4 *UCLA Journal of International and Foreign Affairs* 149, 157-58 (1999) (stating that the GAO study found violations of insider lending rules at 82 of the 175 failed banks and also found preferential insider loans at 70 banks and improper affiliate transactions at 49 banks).
[92] *See* Joseph F. Sinkey , Jr., *Problem and Failed Institutions in the Commercial Banking Industry* 218-33 (1979).
[93] *Id.* at 198-205.
[94] Wilmarth, "Transformation," supra note 66, at 456 n.1058.
[95] GAO-ILC report, supra note 9, at 59-60 (discussing failures of Pacific Thrift and Loan in 1999 and Southern Pacific Bank in 2003).

and 23B. While the violations of Sections 23A and 23B were not the primary reason for the ILCs' failures, those violations were symptomatic of fundamental inadequacies in the management policies, audit practices and compliance procedures of both institutions.[96] The foregoing evidence from thrift, bank and ILC failures creates serious doubts about the effectiveness of restrictions on affiliate transactions and insider lending in preventing abusive and unsound transactions between ILCs and their corporate owners.[97]

Moreover, the restrictions in Sections 23A and 23B are complex and difficult to enforce, and managerial evasions of those provisions are often subtle and difficult to detect.[98] The challenges of detecting abusive affiliate transactions are magnified when a large commercial firm controls an FDIC-insured bank. As one analyst observed:

> Given that the banking regulators are already overburdened with the task of controlling bank soundness, it is quite unrealistic to expect them to monitor and detect more subtle bias in the vast array of loans that banks would make to commercial affiliates, their suppliers and their customers if the mixing of banking and commerce were permitted.[99]

The debacles at Lincoln Savings and Enron demonstrate how complex structures can be used to mask manipulative transactions with affiliates. The parent company of Lincoln Savings caused the thrift to enter into complicated deals involving sham sales of assets to "straw" buyers. Those deals generated fictitious accounting "profits," which Lincoln then transferred to its parent pursuant to an abusive "tax sharing agreement."[100] Similarly, Enron entered into a myriad of commodity swaps and sales of assets with off-

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[96] *Id.* at 59-61; Wilmarth, supra note 1, at 1597.
[97] *See* GAO-ILC Report, supra note 9, at 61 (reporting the view of FRB officials that "focusing supervisory efforts on transactions covered by sections 23A and 23B will not cover the full range of risks that insured institutions are exposed to from holding companies and their subsidiaries").
[98] Wilmarth, "Transformation," supra note 66, at 456, 457 n.1060; *see also* Lemieux, supra note 91, at 154-57.
[99] Brown, supra note 79, at 6-7; *see also id.* at 44 (stating that "serious questions arise as to the [federal banking] agencies' ability to prevent preferential lending and unsound loans in situations where conflicts of interest or external pressures impinge on the credit judgment process").
[100] Wilmarth, supra note 1, at 1577.

balance-sheet, special–purpose entities that were purportedly independent but were actually controlled by Andrew Fastow, Enron's chief financial officer. Like the Lincoln Savings transactions, Enron's structured-finance deals were elaborate shams that were created for the purpose of producing fictitious profits and deceiving credit ratings agencies and institutional investors.[101] The Lincoln and Enron scandals raise further questions concerning the ability of federal regulators and market professionals to identify and evaluate transactions that are designed to benefit affiliates but are disguised by complex financial structures.

Perhaps most disturbing is the possibility that federal regulators might decide to waive affiliate transaction rules so that ILCs could support their commercial affiliates during a major crisis. After the terrorist attacks on September 11, 2001, federal regulators suspended the application of Section 23A and encouraged major banks to transfer large amounts of funds to their securities affiliates to prevent a liquidity crunch that could have paralyzed the securities markets and threatened the survival of leading securities firms.[102] Similarly, in August 2006, the FRB granted temporary waivers to the three largest U.S. banks (Citigroup, Bank of America and JP Morgan Chase) so that those institutions could make large fund transfers in excess of Section 23A limits to support their securities affiliates during the subprime funding squeeze.[103] The ownership of ILCs by huge commercial firms increases the likelihood that regulators would similarly feel compelled to waive legal restrictions on affiliate transactions whenever the parent

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[101] *See* Arthur E. Wilmarth, Jr., "Conflicts of Interest and Corporate Governance Failures at Universal Banks during the Stock Market Boom of the 1990s: The Cases of Enron and WorldCom," George Washington University Law School Legal Studies Research Paper No. 234, Nov. 20, 2006 (available at ssrn.com/abstract=952486), at 10-20.
[102] Wilmarth, "Transformation," supra note 66, at 456-57, 472-73.
[103] Rob Blackwell, "Fed Allows JP Morgan Chase Transaction," *American Banker,* Aug. 29, 2007, at 3; Barbara A. Rehm, "Fed Lets 2 Banks Lend to Affiliates," *American Banker*, Aug. 27, 2007, at 20.

company's survival is threatened, because of concerns that the parent's failure could trigger a major economic crisis.

ii. Evidence from Japan, South Korea and Mexico

Major financial crises occurred in Japan, South Korea and Mexico during the 1990s. Each of those crises was due in part to ownership and control links that existed between banks and commercial firms. Each episode indicates that joint control of banks and commercial firms creates conflicts of interest, distorts economic incentives and increases the risk of a systemic crisis.

Analysts have offered many reasons for the severity and prolonged nature of the economic and financial crisis that afflicted Japan during 1990-2005. Three of those reasons are relevant to this analysis. First, the cross-shareholding relationships between Japanese banks and their corporate lending customers meant that the financial and commercial sectors in Japan were closely linked in 1989. Problems arising in one sector inevitably spilled over into the other. The tightly interwoven ownership and credit linkages between banks and their commercial customers significantly increased Japan's vulnerability to a systemic economic crisis.[104]

Second, due to the tremendous financial and political costs of dealing with the banking crisis, Japanese regulators and politicians adopted a variety of forbearance measures designed to postpone the day of reckoning. In this regard, they acted in a manner that was very similar to the actions of U.S. regulators and politicians during the savings and loan crisis of the 1980s. Japanese officials did not directly confront the banking industry's problems until large banks began to fail in 1997-98.[105]

[104] Wilmarth, supra note 1, at 1599-1600; Wilmarth, "Transformation," supra note 66, at 451-53.
[105] Wilmarth, supra note 1, at 1600.

Third, in order to avoid recognizing loan losses and to support their most important borrowers, Japanese banks followed a policy of "evergreening" – *i.e.,* banks kept rolling over or restructuring loans that were in default. A recent study found that, during 1993-99, Japanese banks were more likely to "evergreen" loans if (i) they had a large credit exposure to the borrower, (ii) the borrower was a member of the bank's corporate group (*keiretsu*), (iii) the borrower was in weak condition, or (iv) the borrower did not have access to the bond markets and was therefore dependent on bank loans. Thus, a major reason for the Japanese economy's failure to improve during the 1990s was that main banks focused their lending on borrowers that were in the weakest condition and were most closely connected to the banks. As a consequence, bank credit was misdirected toward "zombie" firms, and credit was denied to more profitable firms that did not have close connections to banks.[106] In sum, Japan's experience indicates that control linkages between banks and commercial firms seriously distort the allocation of credit, increase the economy's vulnerability to systemic crises and impede the economy's ability to recover from an economic downturn.

South Korea's financial crisis of 1997-98 offers striking parallels to Japan's travails. Like Japan, South Korea maintained a bank-centered financial system from the 1950s through the 1990s, and South Korea's system contained similar cross-shareholding networks and lending relationships between large banks and major corporate groups (*chaebol*). As the government progressively liberalized its financial regulations during the 1990s, Korean commercial banks and newly-organized merchant banks continued to

[106] Joe Peek & Eric Rosengren, "Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan," 95 *American Economic Review* 1145, 1150-65 (2005); *see also* Richard J. Caballero, Takeo Hoshi & Anil K. Kashyap, "Zombie Lending and Depressed Restructuring in Japan," National Bureau of Economic Research Working Paper 12129, Mar. 2006, *passim.*

expand their lending to Korean businesses. By the mid-1990s, the thirty largest *chaebol* were highly leveraged, as their average debt-equity ratio exceeded 500 percent. The *chaebol* relied on overly-generous bank credit to build up excess capacity in steel, shipbuilding, automobiles and semiconductors – industries that were vulnerable to competition from lower-cost foreign suppliers. Korean banks were also fragile, because they relied heavily on loans from foreign banks. Thus, both the *chaebol* and their Korean bank sponsors were highly vulnerable to a sudden withdrawal of international credit.[107]

The economic crisis that struck Thailand, Indonesia and Malaysia in 1997 led to increasing concerns among foreign investors and foreign banks about the solvency of Korean banks and businesses. Foreign banks reduced their credit lines to Korean borrowers, and foreign investors began to liquidate their Korean investments. The Korean stock market crashed, leading to a wave of corporate failures. In 1998, two large banks failed and were nationalized by the South Korean government, and the government also provided support for five acquisitions of other failing banks. The government protected all depositors and ultimately spent about $100 billion to restructure and recapitalize the Korean banking system.[108]

Thus, the Korean crisis of 1997-98, like the Japanese debacle, can be attributed in substantial part to incestuous ownership and credit links between banks and large corporate groups. Korean banks and Japanese banks extended credit to their principal corporate borrowers long past the point of prudence. Similarly, preferential lending by banks to related entities was an important factor in the Mexican financial crisis of 1994-95. Like the Korean banks, Mexican banks relied heavily on foreign credit to expand

[107] Wilmarth, supra note 1, at 1601-02.
[108] *Id.* at 1602-03.

their loans to Mexican businesses and consumers. In addition, the banks extended many of their loans to controlling shareholders and their affiliates. Accordingly, the banks were highly vulnerable to a downturn in the Mexican economy in 1994.[109]

In response to the exchange rate crisis that began in December 1994, the Mexican government devalued the peso and imposed highly restrictive monetary and credit policies. The government's policies produced a dramatic rise in interest rates. Higher interest rates and the peso's devaluation triggered a massive wave of loan defaults. To prevent a collapse of the Mexican banking system, the government injected large amounts of capital into the banks and guaranteed all deposits. Foreign banks acquired four of the five largest banks in Mexico and controlled eighty-two percent of Mexico's banking assets by the end of 2003. Estimates for the total cost of resolving Mexico's banking crisis range between $65 billion and $104 billion.[110]

A study by Rafael La Porta and others determined that loans by Mexican banks to related parties were correlated with bank failures, were made on highly preferential terms, and performed much worse than loans to unrelated parties. The proportion of loans to related parties was substantially higher at the thirteen banks that failed as compared with the five banks that survived. In addition, loans to related parties were made on terms that were substantially less favorable to the banks, in comparison with loans made to non-affiliates. The study concluded that "[t]he case of Mexico in the 1990s suggests that the risk that related lending may lead to looting is great when banks are controlled by industrial firms, outside lending has relatively low rates of return, and

[109] Wilmarth, supra note 1, at 1603-05.
[110] *Id.* at 1605-06.

corporate governance is weak."[111] In sum, the Mexican financial crisis of 1994-95 – like the Japanese and Korean crises – creates serious doubts about the wisdom of permitting joint control of banks and commercial firms.[112]

c. Risks of Contagion from Commercial Owners to ILCs

A further risk confronting a commercially-owned ILC is that its parent company may encounter serious problems that cause the public to lose confidence in the ILC itself. For example, when Beverly Hills Bancorp (BHB) defaulted on $13 million of commercial paper in 1973, the default destroyed public confidence in BHB's subsidiary, Beverly Hills National Bank (BHNB). BHB had used the proceeds of the commercial paper to make loans to a real estate developer. When the developer defaulted on the loans, BHB could not pay off the commercial paper. In announcing its default, BHB assured the public that its own problems would not impair the safety and soundness of BHNB. BHNB's primary regulator, the Comptroller of the Currency, also publicly stated that BHNB was "in solvent condition with satisfactory liquidity."[113] Nevertheless, depositors soon launched "large-scale runs" against BHNB, and BHNB was sued by customers who had purchased BHB's commercial paper. To prevent BHNB's failure,

[111] Rafael La Porta et al., "Related Lending," 118 *Quarterly Journal of Economics* 231, 252-62 (2003) (quote at 262).
[112] Foreign banking crises in the 1930s similarly indicate that ownership links between banking and commercial firms create a higher risk of systemic financial crises. During the 1930s, nations with prominent universal banks (e.g., Austria, Belgium, France, Italy and Germany) experienced severe banking crises because their banks were weakened by close ownership and lending connections to troubled industries. In contrast, Canada and the United Kingdom – whose banks were barred from securities underwriting and dealing and could not own equity interests in commercial firms – did not experience a significant banking crisis during the 1930s. *See* Wilmarth, supra note 1 at 1606 n.383.
[113] Douglas W. Cray, Bancorp on Coast Reveals Problems, N. Y. Times, Dec. 31, 1973, at 27 (quoting Comptroller of the Currency James E. Smith).

regulators arranged a sale of BHNB's assets to Wells Fargo Bank in January 1974. BHNB was thereafter liquidated.[114]

Similarly, when Drexel Burnham declared bankruptcy in February 1990, following the collapse of the junk bond market, its problems quickly spread to two of its subsidiaries, which were securities broker-dealers regulated by the SEC. The regulated subsidiaries were solvent at the time of Drexel Burnham's failure, but the SEC was soon obliged to liquidate them after they could not obtain even short-term credit from counterparties or banks.[115] The contagion resulting from the failures of BHB and Drexel Burnham indicates that investors, depositors and other creditors do not believe that a regulated financial institution can be effectively shielded from serious problems occurring at its parent company.

Problems at U.S. automobile manufacturers have repeatedly caused credit ratings agencies to cut their ratings for the manufacturers' captive finance subsidiaries. During 1991-92, credit ratings agencies reduced the ratings of Chrysler Financial Corp. (CFC) to junk bond level and thereby cut off CFC's ability to issue commercial paper, because of serious financial and operational problems at its CFC's parent, Chrysler Corporation. Similarly, in recent years Ford Motor Credit Co. (FMCC) lost its investment-grade rating and was downgraded to junk bond status because of doubts among ratings agencies about the long-term viability of FMCC's parent, Ford Motor Co. (Ford). General Motors Acceptance Corp. (GMAC), the finance subsidiary of General Motors Corp. (GM), also

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[114] Wilmarth, supra note 1, at 1607.

[115] *See* William S. Haraf, "The Collapse of Drexel Burnham Lambert: Lessons for the Bank Regulators," *Regulation*, Winter 1991, at 22, 23-24; Wilmarth, "Transformation," supra note 66, at 327-38, 356 n.591, 412, 446 n.1029. *See also* Brown, supra note 79, at 23 (quoting SEC chairman Richard Breeden's testimony before a Senate committee, in which he stated that Drexel Burnham's insolvency "appears to have shattered the trust and confidence of the dealer and banking community in the subsidiary broker-dealer, even though it remained solvent with considerable excess liquid assets").

saw its credit ratings fall to junk bond levels because of the ratings agencies' concerns about GM's severe challenges.[116]

In 2006, GM agreed to sell a majority stake in GMAC to an outside investor group for $14 billion. GM needed the sale proceeds to help finance its restructuring program, and GM also hoped that its sale of control of GMAC would improve GMAC's chances of regaining its investment-grade status. GMAC had acquired a Utah-chartered ILC in 2004, and GM therefore applied to the FDIC for permission to transfer control of the ILC to GMAC's new majority owner. In November 2006, despite the FDIC's moratorium covering ILC applications, the FDIC approved GM's application.[117] In explaining its decision to exempt GM's application from the moratorium, the FDIC stated that "waiting to act until after the expiration of the moratorium could have had a significant adverse effect on GM's restructuring and GM's subsidiaries."[118] The FDIC's approval indicated that the agency felt obliged to make an exception due to "unique circumstances" involving a large and troubled commercial parent company.[119]

It is not inconceivable that Wal-Mart and Home Depot could someday find themselves in positions similar to GM and Ford. The growth rate for Wal-Mart's domestic sales has declined sharply in recent years, because (i) Wal-Mart's superstores have reached a saturation point in its traditional rural markets, and (ii) Wal-Mart has encountered significant opposition as it has attempted to build superstores in metropolitan markets. Since 2005 Wal-Mart's sales have grown at a much slower rate than the sales of

[116] Wilmarth, supra note 1, at 1607-08.
[117] *Id.* at 1608-09.
[118] Fed. Deposit Ins. Corp., Press Release, "FDIC Board Approves Change in Control Notice for GMAC Automotive Bank, Midvale, Utah" (available at www.fdic/gov/news/news/press/2006/pr06103.html), at 2.
[119] *See id.* at 1 (stating that "[t]he FDIC acted on this change of control notice prior to the expiration of the [ILC] moratorium because of the unique circumstances of this case").

Target, its main rival. Wal-Mart has tried to offset its slowing growth in domestic markets by aggressively expanding its operations in foreign markets. However, Wal-Mart's international efforts have met with mixed success. While Wal-Mart has profitable operations in Brazil, Canada, Mexico and the United Kingdom, it withdrew from Germany and South Korea in 2006, after suffering heavy losses.[120] Wal-Mart has made its biggest overseas push in China, where it has acquired a substantial chain of retail stores. In addition, about seventy percent of the products Wal-Mart sells are produced in China. Because of its increasing dependence on China, Wal-Mart is exposed to substantial risk from either a significant upward revaluation of the Chinese yuan or a major disruption in the Chinese economy.[121]

Home Depot's results in 2006 were even more disappointing than Wal-Mart's. Home Depot's annual net profit declined in 2006 for the first time in the company's history. Like Wal-Mart, the growth of Home Depot's sales has slowed considerably as its rapid expansion during the prior two decades has apparently reached a saturation point. In addition, Home Depot pursued an ill-conceived cost reduction program that replaced skilled, full-time employees with inexperienced, part-time workers. The resulting decline in service quality alienated many of Home Depot's customers, who migrated to Lowe's (Home Depot's principal competitor). As a result of these setbacks, the chairman of Home Depot was forced to step down at the beginning of 2007.[122]

The recent problems experienced by Wal-Mart and Home Depot – like the much greater difficulties confronting GM and Ford – demonstrate that no manufacturer or

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[120] Wilmarth, supra note 1, at 1609-10; Gary McWilliams, "Wal-Mart Era Wanes Amid Big Shifts in Retail," *Wall Street Journal*, Oct. 3, 2007, at A1.
[121] Wilmarth, supra note 1, at 1610.
[122] *Id.*

retailer is "too big" to be immune from the threat of failure in a globalized and highly competitive economy. Two of the largest U.S. retailers – Kmart and Montgomery Ward – filed for bankruptcy during the domestic economy's most recent downturn during 2000-02.[123] Similarly, Sears failed in its efforts to build a "financial supermarket" during the 1980s. Sears acquired a thrift institution (Sears Savings Bank), an insurance company (Allstate), a securities broker (Dean Witter), a credit card company (Discover), and a real estate broker and mortgage banker (Coldwell Banker). However, Sears sold or spun off all those units by the early 1990s after they failed to produce the profits and synergies Sears anticipated. Subsequently, Sears sold a large credit card business that it built up during the 1990s, after that unit generated high rates of delinquencies and charge-offs. A major reason for the credit card unit's problems was that Sears aggressively expanded credit lines and eased credit terms to encourage cardholders to buy more products from Sears. Sears' problems with its credit card unit provide further evidence of the potential dangers of allowing commercial firms to use ILCs as sources of credit to finance their product sales.[124]

The highly coordinated marketing strategies of today's conglomerates are yet another factor that increases the risk of contagion within holding companies. Large financial conglomerates and their commercial rivals have emphasized the importance of a unified brand as a key strategy to promote their efforts to cross-sell a variety of products to their customers. Several of the commercial firms that have already acquired ILCs – e.g., BMW, Target, Toyota and Volkswagen – have applied the parent's brand name to the ILC. Similarly, Wal-Mart intended to use the name "Wal-Mart Bank" for its

[123] *Id.* at 1610-11.
[124] *Id.* at 1611-12.

proposed ILC. Common brand names and cross-selling programs aggravate the risk that consumers, investors and creditors will perceive problems at commercial parent companies as direct threats to the safety and soundness of their captive ILCs.[125]

3. Does the FDIC Have Adequate Supervisory Powers to Control the Risks Created by Commercially-Owned ILCs?

The FDIC currently does not have authority to exercise consolidated supervision over commercial firms that control ILCs. Even if Congress gave the FDIC consolidated supervisory authority over such firms, this new power would create at least four serious problems. First, the FDIC lacks the experience and expertise to identify and control the risks created by commercial affiliates of ILCs. Second, the FDIC's designation as consolidated supervisor would lead market participants to expect that the federal safety net would be available to commercial parent companies of ILCs. Third, attempts by regulators to control the activities of commercial affiliates would significantly increase the amount of governmental interference in the general economy. Fourth, large commercial owners of ILCs would be likely to enjoy substantial political influence, which they could use to extract costly subsidies or forbearance measures from legislators and regulators.

a. The FDIC's Lack of Consolidated Supervisory Authority over ILC Holding Companies

Federal law currently imposes three significant limitations on the FDIC's authority to supervise an ILC's parent holding company and the nonbank subsidiaries of that company. First, the FDIC has only a limited power to examine the parent company or one of its nonbank subsidiaries. The FDIC may examine an "affiliate" of the ILC – a category that includes the parent company and each of its nonbank subsidiaries – but only

[125] *Id.* at 1612-13.

to the extent "necessary to disclose fully – (i) the relationship between [the ILC] and any such affiliate; and (ii) the effect of such relationship on the [ILC[."[126] Thus, the FDIC's examination authority over the parent company or a nonbank subsidiary is limited to identifying the "relationship" which that company has with the ILC and determining whether that "relationship" has the potential to harm the ILC. The FDIC does not have authority to examine the parent holding company and its nonbank subsidiaries for the purpose of evaluating the overall safety and soundness of the holding company.[127]

Second, the FDIC cannot impose capital requirements on the parent company of an ILC or on any of its nonbank subsidiaries. The FDIC has authority to establish capital requirements only with respect to state nonmember banks, including ILCs.[128] The FDIC could insist, as a condition of approving deposit insurance, that an ILC's parent company must enter into a capital maintenance agreement with the FDIC. Under such an agreement, the FDIC could require the parent company to maintain the ILC's capital at specified levels in order to maintain the ILC's status as an FDIC-insured bank.[129] However, the FDIC cannot dictate the capital structure of the parent company or its nonbank subsidiaries.[130]

Third, the FDIC has only limited authority to bring administrative enforcement proceedings (including actions for cease-and-desist orders or civil money penalties)

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[126] 12 U.S.C. § 1820(b)(4)(A). The term "affiliate" includes any company that controls, is controlled by, or is under common control with, an ILC. *Id.* §§ 1813(w)(6), 1841(k).
[127] *See* GAO-ILC Report, supra note 9, at 33-35, 38-41.
[128] 12 U.S.C. §§ 1813(q)(3), 1831*o*(c), 3902(1), 3907(a).
[129] *See* GAO-ILC Report, supra note 9, at 36-38, 41-43; *see also* 12 U.S.C. § 1816(2) (listing the "adequacy of the depository institution's capital structure" as one of seven criteria that the FDIC must consider in deciding whether to grant an application for deposit insurance). The FDIC can enforce a capital maintenance agreement by bringing administrative proceedings under 12 U.S.C. § 1818, or under the prompt corrective action provisions of 12 U.S.C. § 1831*o*.
[130] *See* GAO-ILC Report, supra note 9, at 43 (stating that "FDIC officials told us that it has never imposed capital requirements on a holding company").

against the parent company of an ILC or its nonbank subsidiaries.[131] For purposes of its enforcement authority, the FDIC can treat the ILC's parent company as an "institution-affiliatied party" (IAP), because that term includes a controlling shareholder (other than a bank holding company) of a state nonmember bank.[132] However, the FDIC cannot treat a nonbank subsidiary of the parent company as an IAP unless it "participates in the conduct of the [ILC's] affairs."[133] In addition, the FDIC may not bring an enforcement action against an IAP unless that person (i) has engaged or is about to engage in an unsafe or unsound practice in conducting the business of the ILC, or (ii) has violated or is about to violate a law, rule or written agreement or condition imposed by the FDIC.[134] Thus, the FDIC's enforcement authority does not extend to nonbank subsidiaries of the parent company that are not IAPs, Moreover, the FDIC cannot bring action against an IAP based on alleged unsafe or unsound practices that are not directly related to the ILC's business.[135]

In contrast to the limited, "bank-centric" authority of the FDIC over ILCs and their affiliates, the FRB enjoys consolidated supervisory powers over bank holding companies and their nonbank subsidiaries.[136] With certain limitations, the FRB can examine a bank holding company and all of its subsidiaries,[137] and can impose capital

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[131] For the FDIC's authority to bring administrative enforcement actions against state nonmember banks, *see* 12 U.S.C. §§ 1813(q)(3), 1818(b), (c), (i); McCoy, supra note 56, § 13.03.
[132] 12 U.S.C. § 1813(u)(1);
[133] *Id.* § 1813(u)(3).
[134] *Id.* §§ 1818(b)(1), (c)(1), (i)(2).
[135] *See* GAO-ILC Report, supra note 9, at 34-38, 46-47.
[136] *Id.* at 29-31 (quote on 30).
[137] *See* 12 U.S.C. § 1844(c)(2); *see also* McCoy, supra note 56, § 12.04 [1][a][ii] (explaining that, to the fullest extent possible, the FRB is required (i) to limit its examination to the bank holding company and any subsidiary that could have a materially adverse effect on the safety and soundness of the holding company's subsidiary banks, and (ii) accept examination reports prepared by regulators of functionally regulated subsidiaries of the holding company).

requirements on the holding company and all of its nonbank subsidiaries.[138] Under the "source of strength" doctrine, the FRB may require a bank holding company to make capital contributions to a subsidiary bank or to provide other types of financial or managerial support.[139] The FRB can bring administrative enforcement proceedings against a bank holding company or any of its nonbank subsidiaries.[140] In addition, the FRB can require a bank holding company to divest any nonbank subsidiary or any nonbanking activity that presents "a serious risk to the financial safety, soundness, or stability" of one or more of the holding company's subsidiary banks.[141] By virtue of its consolidated supervisory powers, the FRB can take "a systemic approach" that encompasses the bank holding company and all of its nonbank subsidiaries, and that addresses "financial and operations risks within the holding company system that can threaten the safety and soundness of a bank subsidiary."[142]

The recent failures of two ILCs – Pacific Thrift and Loan (PTL) and Southern Pacific Bank (SPB) – show the potential dangers of relying on a bank-focused approach in supervising ILCs that are subsidiaries of holding companies. The FDIC began issuing administrative enforcement orders against PTL in 1992, but apparently the FDIC did not attempt to examine PTL's parent holding company until 1998. The FDIC discovered that the parent holding company had incurred large amounts of debt and had transferred borrowed funds to PTL, thereby enabling PTL to keep making high-risk loans that

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[138] *See* 12 U.S.C. §§ 1813(q)(2)(F), 1831*o*(c), 3902(1)(A), 3907; 12 C.F.R. Part 225, App. A-E (setting forth the FRB's capital requirements for bank holding companies). *But see* 12 U.S.C. § 1844(c)(3) (limiting the FRB's authority to establish capital requirements for functionally regulated subsidiaries of bank holding companies).

[139] The FRB's "source of "strength" doctrine, which is set forth in 12 C.F.R. § 225.4(a)(1), was implicitly endorsed by Congress in GLBA. *See* McCoy, supra note 56, § 4.05, at 4-53 through 4-55; GAO-ILC Report, supra note 9, at 32.

[140] *See* 12 U.S.C. §§ 1813(q)(2)(F), 1818(b), (c), (i)

[141] *Id.* § 1844(e)(1)

[142] GAO-ILC Report, supra note 9, at 30, 40.

ultimately caused PTL's failure .in November 1999. Similarly, the FDIC began taking enforcement actions against SPB in September 1996, but did not make an on-site visit to SPB's parent holding company until February 2001. The FDIC discovered that the parent holding company had itself been experiencing significant losses since 1998 and could not provide sufficient capital support to prevent SPB from failing in February 2003.[143] The failures of PTL and SPB indicate that

> the bank-centric approach alone is not sufficient to assess all the risks that a holding company and affiliates can pose to an insured financial institution. . . . [In contrast,] consolidated supervision provides [the FRB's] examiners with both the ability to understand the financial strength and risks of the overall [bank] holding company . . . and the authority to address significant management, operations, capital, and other deficiencies throughout the organization before these deficiencies pose a danger to affiliate insured banks and the bank insurance fund.[144]

Similarly, the SEC acknowledged after the collapse of Drexel Burnham in 1990 that it "did not have adequate information regarding the Drexel holding company and its unregulated affiliates."[145] The lack of such information "severely hindered" the SEC's ability to evaluate the threat posed to Drexel Burnham's broker-dealer subsidiaries, including the "ability to know of the imminence of a liquidity crisis for the parent, and the corresponding risk that the broker-dealer's capital could be depleted in a desperate but fruitless attempt to pay the parent firm's unsecured creditors."[146] In 2004, the SEC adopted a new consolidated supervisory approach, which applies on a voluntary basis to

[143] Wilmarth, supra note 1, at 1615-16.
[144] GAO-ILC Report, supra note 9, at 61-62 (reporting views of FRB officials).
[145] Brown, supra note 79, at 25 (quoting testimony of SEC chairman Richard Breeden).
[146] *Id.* (same).

"supervised investment bank holding companies" (SIBHCs) that own securities broker-dealers.[147]

In February 2007, the FDIC expressed its concern that "the current supervisory process and infrastructure [for ILCs] may not produce the safeguards that the FDIC believes could be helpful" in evaluating and controlling the risks presented by ILC holding companies that are not subject to consolidated supervision by either the FRB or the OTS.[148] The FDIC therefore issued a proposed regulation, which would apply to any holding company that (i) is engaged solely in financial activities, (ii) proposes to acquire control of an ILC, and (iii) would not be subject to consolidated supervision by the FRB or the OTS. The FDIC's proposed regulation would require such a holding company to enter into a written agreement with the FDIC as a condition for acquiring control of the ILC. The agreement would require the parent holding company to (i) provide information and reports to the FDIC concerning the operations of itself and its nonbank subsidiaries, (ii) allow the FDIC to examine the holding company and each of its subsidiaries, and (iii) maintain the ILC's capital at specified levels.[149]

It is not entirely clear whether the FDIC has authority to force companies that acquire ILCs to enter into the consolidated supervision agreement described in the FDIC's proposed regulation.[150] However, the proposed regulation does make clear that the FDIC is no longer comfortable in providing deposit insurance to ILCs whose parent companies are not subject to consolidated supervision by a federal banking agency.

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[147] Wilmarth, supra note 1, at 1616 & n. 439 (stating that holding companies that own securities broker-dealers can voluntarily register with the SEC as SIBHCs in order to satisfy the requirements of the European Union's Conglomerates Directive).
[148] FDIC Moratorium Extension Notice, supra note 2, at 5293.
[149] FDIC Proposed Rule on Consolidated Supervision, supra note 17, at 5222-27.
[150] *Compare id.* at 5223 (contending that the FDIC possesses authority to adopt the proposed regulation) *with* GAO-ILC Report, supra note 9, at 45-46 (indicating some doubt whether the FDIC has authority to impose consolidated supervisory requirements on applicants who seek to acquire ILCs).

b. Providing the FDIC with Consolidated Supervisory Authority over Commercial Parent Companies of ILCs Would Have Adverse Consequences

The problems arising out of acquisitions of ILCs by commercial firms cannot be solved simply by establishing the FDIC as the consolidated supervisor of such firms. To the contrary, the designation of a federal consolidated regulator for commercial parent companies of ILCs would have at least four negative effects. First, the FDIC does not have any substantial experience or specialized expertise in evaluating the safety and soundness of commercial conglomerates. Naming the FDIC as consolidated supervisor for commercial parent companies of ILCs would greatly increase the FDIC's supervisory burden and would compel the FDIC to hire new personnel with expertise in many different sectors of the U.S. economy.[151]

Second, the FDIC's designation as consolidated regulator would have the undesirable effect of implying that the federal government is monitoring and assuring the overall solvency and stability of each commercial firm that owns an ILC. That implication could lead market participants to expect that the federal safety net would potentially be available to commercial parent companies of ILCs.[152]

Third, federal consolidated supervision of commercial owners of ILCs would greatly expand the scope of federal regulation within the commercial sector of our economy. From the 1950s through the 1990s, governmental authorities in Japan and South Korea played an extensive role in monitoring and directing the relationships between main banks and their commercial clients. Government regulators frequently

[151] *See, e.g.*, Brown, supra note 79, at 4, 24-25, 42-45, 47; Statement by E. Gerald Corrigan, President, Federal Reserve Bank of New York, before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, April 11, 1991, reprinted in 77 Fed. Res. Bull. 411, 418-19 (1991).

[152] Statement by E. Gerald Corrigan, supra note 151, at 418-20.

pressured banks to provide credit to designated high-growth industries or to provide support for troubled commercial firms. Giving the FDIC a similarly intrusive role in monitoring dealings between banks and their commercial affiliates could significantly weaken the market-driven dynamics of the U.S. economy.[153]

Federal law currently requires the FDIC to oversee every transaction that results in the transfer of control of an ILC's parent company. As shown by GM's recent sale of control of its subsidiary ILC, the Change in Bank Control Act (CBCA)[154] requires the FDIC to review, and to decide whether to disapprove, any proposed change in control of a state nonmember bank.[155] The CBCA provides a significant impediment to any hostile takeover of a parent company of an ILC,[156] and the CBCA therefore undermines the effectiveness of the takeover market in disciplining managers of such companies.

Fourth, major commercial firms that acquire ILCs are likely to use political influence to obtain subsidies or forbearance from regulators. Big commercial firms that own ILCs are likely to be not only TBTF but also "too big to discipline adequately" (TBTDA).[157] Major banks have proven to be TBTDA in the past. For example, during the banking crisis of 1984-92, Bank of America and Citicorp, the two largest U.S. banks, each came perilously close to failure. However, federal regulators did not take any public enforcement actions against the banks or insist upon a replacement of their managers. Instead, regulators quietly entered into nonpublic "memoranda of understanding," the

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[153] Wilmarth, supra note 1, at 1599-1603, 1618; Statement by E. Gerald Corrigan, supra note 151, at 419.
[154] 12 U.S.C. § 1817(j).
[155] *See* McCoy, supra note 56, § 10.02[1][a]; supra notes 117-19 and accompanying text (discussing the FDIC"s approval of GM's sale of control of its ILC).
[156] *See* Wilmarth, "Transformation," supra note 66, at 291-92 (explaining that hostile takeovers of banks rarely occur, because "[r]egulatory approval requirements for bank mergers create significant obstacles to hostile takeovers").
[157] TBTDA is a term coined by Professor Edward J. Kane. *See* Kane, Megamerger Incentives, supra note 65, at 673.

weakest form of enforcement action, with both banks. Regulators evidently were unwilling to take strict enforcement measures against either bank because they feared that public disclosure of the bank's problems might trigger a generalized loss of public confidence in the banking system.[158]

The FDIC's decision in November 2006 to waive its initial ILC moratorium, and to approve GM's sale of control of GMAC and its ILC subsidiary, is suggestive of the type of regulatory forbearance that is likely to be extended to large commercial owners of ILCs. The FDIC's decision was criticized by a well-known bank analyst, who "accused the FDIC of bowing to congressional pressure and showing preferential treatment to certain companies."[159] The FDIC may well have adopted a "pragmatic approach" in removing an obstacle to a transaction that was viewed as "critical to the health of General Motors."[160] However, the FDIC's decision clearly indicates that major companies owning ILCs will receive special consideration from regulators if their financial stability is important to the national economy.

Conclusion

The FDIC made the right decision when it imposed a moratorium on further acquisitions of ILCs by commercial firms so that Congress could consider the need for legislation barring such acquisitions. As shown above, commercial ownership of ILCs conflicts with our policy of separating banking and commerce. In addition, commercially-owned ILCs present significant risks to our financial system and our national economy. Commercial ownership of ILCs is likely to create serious distortions

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[158] Wilmarth, "Transformation," supra note 66, at 304-06.
[159] Joe Adler, "Approval for GM ILC Deal Pleases Industry," *American Banker*, Nov. 17, 2006, at 4 (reporting on statement by analyst Richard X. Bove).
[160] *Id.* (quoting Rep. Gillmor).

and competitive imbalances in our economy by (i) extending TBTF protection to large commercial owners of ILCs and (ii) encouraging ILCs to use their federally-subsidized, low-cost deposits to fund loans that will benefit their parent company's operations. Consolidated supervision of commercially-owned ILCs cannot control these risks and is likely to have additional negative effects. Consolidated supervision would increase the likelihood of TBTF bailouts, because FDIC supervision would cause the market to expect that the federal safety net would be available to commercial owners of ILCs. Moreover, consolidated supervision would require the FDIC to monitor and evaluate the operations of all commercial affiliates of ILCs, thereby producing an even more intrusive federal regulatory presence in the general economy.

Congress should therefore enact legislation to prohibit further acquisitions of ILCs by commercial firms. At present, there are only fifteen such firms, and their number should not be allowed to increase. On four occasions during the past half century – in 1956, 1970, 1987 and 1999 – Congress acted to prevent widespread ownership of FDIC-insured depository institutions by commercial firms. It is time for Congress to do the same thing with respect to ILCs.

Testimony before the Senate Committee on Banking, Housing, and Urban Affairs

The Right Policy for Industrial Loan Companies

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October 4, 2007

Those who oppose the current law as it applies to industrial loan companies (ILCs) argue that allowing nonfinancial companies to acquire ILCs violates the policy of separating banking and commerce. In this testimony, I will review the underlying policy arguments in favor of the separation of banking and commerce and show that the separation idea no longer has any rational policy basis. Instead, the policy now serves principally to protect the banking industry against competition and to deprive consumers of the benefits that would flow from allowing nonfinancial firms to gain access to the functions that are currently available only to insured banks.

For these reasons, Congress should leave the current law on ILCs unchanged. Holding open this opportunity for nonfinancial firms to combine with insured depository institutions will be an important and useful experiment. Congress can watch how this structure works, see the benefits it will provide for consumers and working families, and determine whether any of the supposed dangers actually arise. In the end, I am confident Congress will find that the great hue and cry stirred up about ILCs was wholly unnecessary.

In thinking about the separation of banking and commerce, we should recognize that our economic and regulatory structure accepts very few restrictions on combinations

between companies in different industries. Many of the restrictions that existed in the past—such as a prohibition on railroads owning other modes of transport, or banks affiliating with securities firms—have been abandoned because they were shown to have unduly restricted innovation and competition. In antitrust law, conglomerate mergers—which do not involve either horizontal or vertical integration—generally present no policy problems, and analysts recognize that allowing such combinations generally enhances competition, spurs innovation, and reduces prices for consumers.

Thus, to overcome the presumption that combinations between companies in different industries should be permissible—in other words, to demonstrate a need to prevent nonfinancial firms from acquiring or chartering ILCs—the proponents of restrictive legislation must show some harm to the economy, to consumers, or to some other policy objective.

As I will discuss below, Congress has already decided in the Gramm-Leach-Bliley Act (GLBA) that no harm can result from combinations between banks and other financial organizations, no matter what their size. As I hope to make clear, there is no real difference between financial affiliates and commercial affiliates; they both raise the same issues. Under these circumstances, the only harm that can come from a change in the law is harm to consumers and working families.

The arguments in favor of separating banking and commerce

Those who advocate the continued separation of banking and commerce—and thus restrictions on nonfinancial companies owning ILCs—cite the following potential harms:

- Permitting combination between insured banks and commercial firms could create undue concentration of assets or financial resources;

- If a commercial firm were to control a bank, it might force the bank to lend preferentially to the commercial parent or the parent's affiliates, or forbid the bank from lending to the parent's competitors;

- If a commercial parent were to control a bank, it might misuse the bank as a financing source when the commercial firm needs credit but cannot find it elsewhere because of its weak financial condition. This would, in effect, extend the bank safety net to its commercial parent.

- Commercial activities are riskier than banking activities, and thus the commercial parents of insured banks cannot be sources of strength for their bank subsidiaries.

I will consider these arguments in turn below.

Undue concentration of assets or resources. As noted above, combinations among firms from different industries pose no antitrust problems and are routinely permitted by the Federal Trade Commission and the Department of Justice. In addition, the GLBA imposes no restrictions on the size of the combinations that are permissible under that act. Thus, it would be possible for the largest bank holding company to acquire the largest securities firm and insurance company. This suggests that Congress did not view the threat of large combinations of financial assets as particularly significant.

If large combinations of financial assets were not deemed to be a threat, why

should combinations between commercial firms and financial institutions be prohibited? First, it is necessary to point out that there is no federal law or regulation that prohibits a commercial company from acquiring an insurance or securities firm, no matter what the size. So the relevant question is whether there is something about a commercial company acquiring an insured institution such as a bank or an ILC. Analysis will show that this poses no greater threat than other combinations.

As noted above, there are three possibilities—banks or ILCs will lend preferentially to their commercial parent or the parent's affiliates; they will not lend to competitors of their commercial affiliates; and their commercial affiliates will use the bank as a source of financing when the financial condition of the commercial affiliate is so weak that it is unable to borrow from any other source. This last possibility raises the question of whether the bank safety net might be extended in this manner to a commercial firm.

None of these possibilities has any basis in reality. This is especially true for ILCs, which are small insured institutions, but for the following reasons it is also true for the largest banks:

Preferential lending. If preferential lending is to occur, it must violate federal banking law and regulations. Sections 23A and 23B of the Federal Reserve Act limit loans to all affiliates as a group to 20 percent of a bank's capital, and requires that this lending take place at arms length and be secured by collateral of up to130 percent of the loan. In addition, Section 1818 of the Federal Deposit Insurance Act imposes criminal liability and a possible *personal* fine of up to $1 million per day on any bank official who

approves a violation of banking law or regulations.

Accordingly, it would be irrational for a bank or ILC official to risk a penalty of that kind in order to make a preferential loan to an affiliate.

Indeed, there is good reason to believe that Congress accepts the fact that banking laws and regulations have eliminated the problem of preferential lending. The GLBA permits banks to affiliate with securities firms and insurance companies. Securities firms, in particular, are among the heaviest users of bank credit, which they use to carry their securities trading inventory. If the possibility of preferential lending was not considered significant enough to require special restrictions on lending between banks and affiliated securities firms—other than 23A and 23B—there is no reason to suppose that preferential lending between banks and commercial firms would be more of a problem.

Denial of credit. The GLBA is also relevant for considering whether banks or ILCs that are affiliated with commercial firms might deny credit to competitors of those affiliates. The GLBA makes no special provision for the possibility that banks affiliated with securities firms or insurance companies might refuse to extend credit to the competitors of these affiliates. This is particularly significant because the GLBA was heavily negotiated and was adopted only after the concerns of many interested parties were addressed. There are thousands of securities firms and insurance companies which—directly or through their trade associations—participated in the development of the GLBA, yet the act contains no provision that would address and attempt to prevent the possibility that many of them would have to compete with companies affiliated with banks.

The reason for this is obvious. The are now so many sources of credit in the United States that even if a bank were to refuse to lend to the competitors of its affiliated insurance company or securities firm those competitors would have no trouble getting bank or other financing elsewhere. If Congress did not think denial of credit was a significant danger when it permitted affiliations between banks and securities firms or insurance companies, there is no reason to believe that it would be any more significant if banks or ILCs were affiliated with commercial firms.

Lending to financially troubled affiliates and extending the safety net. What I said above about the laws and regulations applicable to banking is also relevant here. Loans to affiliates must be at arms length, and bank officers who provide credit to a financially weak affiliate are placing themselves and their families at risk for enormous personal fines and criminal charges.

It is likely that it was because of these legal restrictions that Congress was not concerned about this issue when, through the GLBA, it approved the acquisition of banks by securities firms and insurance companies. All financial institutions, including insurance companies and securities firms, can and do encounter financial reverses. Securities firms are particularly fragile—much riskier enterprises than commercial firms—because many of their assets are short term or depend on the continuing loyalty of employees and the goodwill of clients. Yet, in allowing banks to affiliate with securities firms, Congress made no special provisions in the GLBA to prevent bank parents or affiliates from demanding special financial accommodations that might, in effect, spread the bank safety net to cover these organizations.

If Congress did not see the need—beyond Sections 23A and B and the severe penalties in the Federal Deposit Insurance Act—for protecting banks and the safety net against the demands of affiliates or parents such as securities firms, there is no reason to suppose that these demands would be any greater if made by commercial affiliates that own banks or ILCs.

Commercial parents are riskier than banks. This is certainly true, but since the adoption of the GLBA it is not relevant. Securities firms, which can now control banks, are among the riskiest companies in our economy. They are heavily dependent on sales and other personnel who go down the elevator every night. Their customers and employees are also sensitive to the firm's reputation in the market. That's why securities firms such as Kidder Peabody and Drexel Burnham imploded quickly after encountering financial scandals. Commercial firms, in contrast, own their productive assets or control them under enforceable contracts. They are subject to the risk of loss, of course, but not the kinds of implosions that occur in the financial industry.

Once Congress, in the GLBA, allowed securities firms to acquire banks, it in effect conceded that the "source of strength" argument for the continued separation of banking and commerce had no merit.

Accordingly, if we look closely at all the reasons for preserving the policy of separating banking and commerce we find that none of them is significant or remotely persuasive. This is especially true when the effect of the policy is to harm to consumers and working families.

The separation of banking and commerce and the harm to consumers

Frequently we hear the argument that, even if the separation of banking and commerce is not a soundly based policy, what's the harm? Most members of Congress are not regularly approached by constituents who want to acquire banks, so why bother to change the policy? The answer is that as long as this policy keeps companies like retailers, auto manufacturers, and other suppliers of consumer goods out of the banking business it will prevent the full benefits of competition from reaching consumers.

One of the advantages of ILCs is that they allow retailers and others who have substantial credit card charges at their stores to gain access to the payment system—which is permissible only for insured institutions like ILCs and banks—at less cost than if they had to do it through an unaffiliated bank. These lower costs, among other savings, will be passed on to consumers.

In addition, allowing nonfinancial companies to enter into competition with banks will bring more competition, more capital, more innovation and lower costs to the banking industry. This has happened in virtually every case where Congress has deregulated an industry. The influx of new competitors and new capital has been one of the reasons we have such a dynamic economy. The effort to shut down the ILC is basically an effort to prevent this from happening in the banking business. In the end, it will be bad for the banking business—which will be deprived of the benefits of vigorous competition—as well as consumers.

Finally, no one should be under an illusion that if the policy of separating banking and commerce is imposed on ILCs it will still leave ILCs as a viable industry. In fact, it will stop the industry's growth in its tracks. People in Congress may not have noticed, but

the GLBA did not result in securities firms and insurance companies acquiring banks—even though this was permissible. Of the 700 or so financial holding companies that have been formed, only a handful are the result of the acquisition of banks by securities or insurance firms. All the rest are the result of bank holding companies getting into the securities or insurance business.

In other words, the GLBA did not create the two-way street that was advertised. Why not? The reason is that insurance companies and securities firms have been reluctant to acquire banks and thus become subject to the Fed's decision on whether a particular activity they want to enter is "financial in nature."

The perils associated with this are shown by the Fed's inability, over 8 or so years, to declare that real estate brokerage is a financial activity suitable for an FHC. In other words, the GLBA creates a kind of "roach motel"—recalling the old advertisement for a cockroach trap that claimed the roaches went in but never came out. Financial companies such as securities and insurance firms that enter the Fed's jurisdiction by acquiring banks become trapped. Not only do they have to divest the nonfinancial businesses they are already in, but they may be forbidden in the future to enter any other business they believe is necessary for competitive purposes—unless the Fed considers it to be "financial in nature."

This has not been a problem for the bank holding companies. For them the GLBA was liberating; it allowed them to expand into financial areas from which they had previously been excluded. But for securities firms and insurance companies, among others, the separation of finance and commerce—as implemented by the GLBA—creates

a set of unknown future limitations that their managements have not been willing to accept.

The same thing will be true if the separation of banking and commerce is applied to ILCs. Even financial companies will shy away from acquiring or chartering ILCs, because it will mean a billet in another kind of roach motel.

The underlying reasons for the policy.

If there are—as it appears—no valid policy reasons for separating banking and commerce, why does this so-called "principle" still receive support in Congress? The most benign explanation recalls Oliver Wendell Holmes's remark that "[a] good catchword can obscure analysis for fifty years." The idea of separating banking and commerce is a powerful slogan, and it has obscured analysis for even longer than that.

When the policy first made a formal appearance, in a statement to Congress by the Federal Reserve Board in 1938, there might have been some reason for such a rule. At that time, banks were powerful and unique sources of credit in our economy. A robust commercial paper market and lending by finance companies and securities firms were either limited or nonexistent. In addition, banks were geographically confined and could not move from state to state (or in some states from county to county).

For these reasons, banks had real market power in their markets. The denial of credit by a bank was a real threat to the viability of companies and the security of individuals. In addition, bank regulation was not as thoroughgoing as it is today, and bank officers did not face the draconian penalties applied by FDICIA if they violated

restrictions on affiliate lending. Under these circumstances, affiliation with a bank could have been a huge advantage. All that, of course, has now changed. Banks now compete on a nationwide basis, and anyone who collects his or her mail can't miss the fact that banks are aggressively looking for customers. Denial of credit is not a problem.

So one reason that the separation of banking and commerce, as an idea, survives today is that few people in Congress have thought seriously about whether it makes sense any more.

But there are other reasons. Unfortunately, the separation of banking and commerce now serves two interests. The first is the interest of the banking industry in keeping out competition. Companies acquiring ILCs will create new competition for banks. One cannot blame the banking industry for arguing against this new competition—it's an American tradition—but there is no reason for Congress to approve such a policy. It certainly makes stated concerns about consumers and working families seem insincere.

The other party with an interest in the continued separation of banking and commerce is the Federal Reserve Board. The movement of state chartered banks to national charters has meant that the Fed's principal role as a regulator in the banking system is through its regulation of bank holding companies. It's reasonably clear that if the separation of banking and commerce were eliminated and commercial firms could acquire banks, the Fed would no longer be able to maintain its role as regulator of holding companies. This should not be a policy problem; there is no reason why the FDIC or any other federal bank regulator could not—using the powerful laws I've

described—adequately regulate and supervise a bank that is a subsidiary of a commercial firm without any direct control over its parent company.

However, as long as the separation of banking and commerce remains in place, and the Fed—under the GLBA—has the authority to decide what is a financial activity and to regulate bank and financial holding companies, it will retain important power over the banking industry, even though at this point it regulates and supervises very few of the largest banks. So this committee will find the Fed very concerned about relaxing or eliminating the separation of banking and commerce.

What is a financial activity?

Although in this testimony I have treated commercial activities and financial activities as though they are really different, that is not actually true. There is no clear line between commercial activities and financial activities, nor can there be.

The Fed's authority to declare what is a financial activity is actually an impossible task. This is shown by the 8 year old controversy about whether real estate brokerage is a financial activity. Securities brokerage is undoubtedly financial; so is mortgage brokerage. But apparently the status of real estate brokerage is not clear.

What's the distinction? Is it that the thing being brokered, a mortgage or a security, is a financial instrument—a *chose in action* as we called it in law school—and not a tangible thing? If you think that's the distinction, what is a lease? A lease is a way to hold real estate, or a car, or an airplane? Leasing and lease brokerage is clearly a financial activity, but what is transferred though a lease is possession of a tangible thing.

Can real estate agents broker leases? Is a company that leases cars different from a company that buys and resells them? Could a bank or a financial services holding company own a company that leases cars but not one that sells them? What if 60 percent of its revenue or profit is from leasing rather than sales? If this is beginning to sound like counting angels on the head of a pin you can see why the Fed has been given an impossible job.

Congress should end this game by eliminating the reason for drawing these highly artificial distinctions.

Summary

To summarize, then, the separation of banking and commerce has no valid policy basis anymore. In today's world, where credit is readily available to everyone, the separation of banking and commerce simply protects the banking industry against competitive entry by nonbanks and deprives consumers and working families of the lower costs and other benefits they would receive if commercial firms could combine with banks. Accordingly, the elimination of the policy of separating banking and commerce, which would allow nonbanking companies of all kinds to acquire or charter ILCs, is the best kind of pro-consumer legislation. If Congress will leave the law as it is—even as an experiment—it will become clear that separating banking and commerce is not necessary.

TESTIMONY OF BRIGID KELLY
POLITICAL DIRECTOR, LOCAL NO. 1099
UNITED FOOD AND COMMERCIAL WORKERS
INTERNATIONAL UNION

Before a Hearing of the
SENATE BANKING COMMITTEE

October 4, 2007

Thank you Chairman Dodd, Ranking Member Shelby, and Members of the Committee for holding this hearing and for the opportunity to testify. In particular, I would like to thank my Senator, the Honorable Sherrod Brown of Ohio. I am here today representing the United Food and Commercial Workers International Union (UFCW) and Local 1099 from the great states of Ohio, Indiana and Kentucky. Local 1099 represents almost 20,000 members and UFCW represents more than 1.3 million members in the United States and Canada. UFCW represents workers in every state in the U.S., and is the largest private sector union in North America. Our members work in grocery stores, the meatpacking and food processing sectors, as well in the health care industry, in the chemical industry, in department stores, in garment manufacturing, in the production of distillery products and in the textile trades.

I am proud to represent UFCW and our members in Ohio, Indiana and Kentucky to discuss the important issue of regulating Industrial Loan Companies (ILCs). I am

especially proud to represent Ohio, home of the late U.S. Representative Paul Gillmor, who sadly recently passed away. Representative Gillmor was the original cosponsor of the Gillmor-Frank ILC legislation in the House, along with Chairman of the House Financial Services Committee, Representative Barney Frank. This was a very important issue for Congressman Gillmor and I am pleased to be here to carry on the Ohio tradition of fighting to close the ILC loophole and keep banking and commerce separate.

The UFCW recognized the problems with the ILC loophole years ago and our union was one of the founding members of a diverse group of organizations known as the Sound Banking Coalition. In addition to the UFCW, the members of the Coalition include the Independent Community Bankers of America, the National Association of Convenience Stores and the National Grocers Association. The Coalition was created early in 2003 when there were few commercial applicants for ILC charters.

Together with the members of the Sound Banking Coalition, UFCW has analyzed ILCs – their growth, their regulation, and their use by commercial entities for several years. If ILCs are not properly regulated – and we believe that today they are not – the financial safety of working people and all Americans is put at risk. This is particularly true for ILCs owned by commercial entities, which are not subject to consolidated oversight by the Federal Reserve. The growth of commercial ownership of ILCs only makes these risks more acute. The list of risks is long, including everything from reduced consumer protections to insolvency, which can directly affect all of us.

The Sound Banking Coalition is firmly united in our strong support for separating banking and commerce in the United States. Separation of the financial from the commercial spheres has proven to be sound economic policy and it has benefited consumers and workers who might otherwise find themselves at the mercy of a single large firm for not only the goods and services they need, but for their very financial welfare. It has also allowed for the development of a vibrant and competitive financial services industry that offers a multitude of products and services to consumers. The fact that so many commercial firms are now trying to circumvent this bedrock economic policy through a loophole in the law is extremely troubling. We should not allow decades of good policy to be undone through an inadvertent backdoor mechanism.

Commercial ownership of banks creates the potential for two specific and very troubling problems. First, ILCs and their parent companies are not subject to consolidated supervision at the holding company level. Holding companies that own banks in this country are subject to consolidated regulation by the Federal Reserve Board. The Fed examines a bank holding company and all of its subsidiaries to ensure that neither the holding company nor any of the subsidiaries create solvency risks for the bank. More than simply avoiding risk, however, a bank holding company is supposed to be a source of financial strength for its bank subsidiaries, which can be a critical factor for banks that face financial difficulties. The Fed oversees bank holding companies whether the bank itself is a state-chartered bank or a national bank. Non-U.S. bank holding companies can be an exception to this rule, but only if those foreign firms are subject to similar, consolidated supervision in their home countries.

Why should we be such sticklers about this type of regulation in the banking world? Because we have seen bank failures in the past – the savings and loan scandal of the 1980s, for example, as well as many others. And when banks fail, people get hurt and we all end up paying for it one way or another. The savings of real people and real businesses are in these institutions and it is appropriate that we take seriously our obligation to protect people's money. As we have learned over the course of the past century, we are far better off with prudent financial oversight of the entire bank holding company, enabling a strong regulatory agency to understand the institution and to address any problems before they become too big to solve.

We should not hold ILCs to standards lower than those required of bank holding companies and foreign banks. Our obligation to protect people's funds should be the same. Indeed, on one level it is the same: ILC funds are, after all, protected by the same FDIC insurance that covers deposits in all other banks. And the problems with a failure can be just as devastating. During the savings and loan crisis, no one who lost money was comforted by the fact that the institution that failed was called an S&L rather than a bank. For the same reason, calling something an ILC should not change prudent financial regulatory policy. If consolidated supervision is needed for other banks – which we endorse and current law requires – then it should be required for ILCs.

This is a particular concern to us in the state of Ohio. Unlike Indiana, Ohio does not have an ILC charter. So, our commercial companies cannot acquire a bank. But we allow banks from other states to branch into Ohio. This includes state chartered banks

such as ILCs. Some states, including Kentucky, have passed legislation taking different approaches to stop ILCs from branching into their states but Ohio has not. We are concerned that an ILC from another state with inadequate holding company regulation may be able to branch into Ohio unless Congress acts.

The other key regulatory concept that is tremendously important here – and is also something we'd like to protect against in the state of Ohio – is the mixing of banking and commerce. Banks are supposed to be neutral arbiters of capital, providing financing to customers on an unbiased basis, unencumbered by commercial self-interest and competition. If those banks are owned by commercial companies, the conflicts of interest can skew loan decisions and lead to systemic problems. Imagine local businesses having no alternative but to go to a bank owned by a competitor for a loan. This conflict of interest could force local retailers to essentially provide their business plans to their competition. It could also lead local retailers to change business plans, pricing structures, and markets in order to secure financing. These changes might be required by the "lender" and thus inherently suspect, or they might be steps taken by the small business in order to smooth the way to secure financing. Either way, it would be a distortion of the market and potentially very harmful to the business prospects for the small business.

Banks are also an important source of economic opportunity. For individuals who need a loan - including starting and expanding a business - a bank is typically the first place to start. If local banks disappear due to the scorched earth tactics of commercially-owned ILCs, similar to the disappearance of local commercial businesses in recent years,

we are all in for a rude awakening.

This is a large part of the reason Wal-Mart's attempt to buy an ILC was such a threat. We have watched Wal-Mart come into town after town and decimate Main Street, business by business. Studies have documented the impact on employment, wages, benefits, and tax revenue. One area least affected is financial services where access to capital and credit offer lifelines in many communities. Local community banks and other financial institutions are critical to economic vitality. If the capital is there, then new businesses can spring up and the ones that may still be hanging on can reinvent themselves and find ways to compete. Yet, if the local banks are forced out of business and there is no local source of capital, than that community is on life support until, for example, a large multinational retail chain headquartered in Arkansas makes a decision about that local community and its small businesses. And, they know just how to do it, by closing locations and opening regional "superstores."

If Wal-Mart had secured its bank and turned its standard slash and burn tactics against local banks, its economic control in these small communities would have been almost complete. Despite the company's protestations to the contrary, it is abundantly clear that the ILC charter was simply a stepping-stone for Wal-Mart to full consumer banking.

Despite its withdrawal from the ILC market, Wal-Mart continues to loom large over the ILC debate. Although we are pleased that the company withdrew its ILC

application, its bid for a bank put the spotlight on ILCs in general and on the separation of banking and commerce, specifically. This is not surprising given the company's size - and market dominance. Although we have been concerned about the ILC loophole for years, the impact of granting Wal-Mart a charter could not be overstated. It is absolutely certain that if the company had secured a bank through a loophole in the law, the ILC loophole would have been larger than the rule.

Additionally, the withdrawal of one application does not resolve this issue – even with respect to Wal-Mart. Wal-Mart can and most likely will try again. They have tried to get into banking four times now, and only regulations and changes in law have prohibited them. There is no reason to believe that there won't be a fifth attempt. In fact, their history tells us they will be back. Time and again Wal-Mart has withdrawn zoning applications for new stores in the face of opposition – only to return and try to quickly get approval when the opposition has rested. It is a calculated strategy and one we are very familiar with. That is why – in spite of the withdrawal, we continue to support Congressional action to close this loophole.

Even without Wal-Mart, there are now a record number of commercial companies applying for ILC charters. Blue Cross/Blue Shield, Home Depot, Berkshire Hathaway – these and more have followed Wal-Mart's lead thus far. While some applications have been withdrawn, it is clear that there is unprecedented interest in this charter from commercial companies.

Whether or not these commercial entities will succeed in entering the world of banking is up to you. Congress must deal with the policy questions surrounding ILCs before commercial entities, looking to add financial services as simply another business line – along with home repair or health care - make congressional policymaking an afterthought. We must restrict future ILC charters to institutions that are primarily engaged in financial activities and improve the supervision of ILC holding companies.

The FDIC has extended its moratorium on ILC applications submitted by commercial entities. The moratorium will not last forever and, in the meantime, fundamental policy decisions must be made. These decisions are beyond the scope of the FDIC's authority and they are too important to be left to a single state. We believe it is dangerous to let the economic interests of one state dictate the structure and oversight of our nationwide system of banking. With the increasing use of internet banking, ATMs, and banking by phone, this would mean that increasingly one state would be setting the banking rules for all the rest of us.

In addition, Governors and state legislatures have recognized the potential policy problems with ILCs and at least eight of them – including Colorado, Iowa, Kentucky, Maine, Missouri, Nebraska, Oklahoma, and Virginia - have enacted laws to keep ILCs from branching into their states. Our local union is considering following the leads of other unions and forming local coalitions to change Ohio's state law. But it is our belief that the appropriate forum for deliberation and construction of banking policy should be the Congress not individual states. That is why I am here today – to urge the Committee

and the Senate to act. We must close this loophole by restricting future ILC charters to institutions that are primarily engaged in financial activities. The Senate must follow the House's lead and move legislation forward. As you know, the House passed legislation in May by a vote of 371-16.

We believe the Senate must act now and we look forward to working with every Member of this Committee and the Senate. I urge you to address the problems and challenges that I have outlined today. Again, I thank you for your time and would be pleased to attempt to answer any questions that you may have.

TESTIMONY OF
JAGJIT "JJ" SINGH
CHAIRMAN, PRESIDENT AND CEO
TRANSPORTATION ALLIANCE BANK

BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

HEARING ON THE SUPERVISION AND REGULATION OF INDUSTRIAL LOAN COMPANIES

OCTOBER 4, 2007

Mr. Chairman and members of the committee:

I thank you for the opportunity to appear before you today to discuss Transportation Alliance Bank and industrial banks. I am Jagjit (JJ) Singh and I appear today on behalf of the Utah Association of Financial Services which is a trade association representing industrial banks and consumer lenders in Utah and Nevada. I am the President, CEO and Chairman of Transportation Alliance Bank located in Ogden, Utah. Transportation Alliance Bank provides a full range of banking services to the interstate Trucking Market Segment.

Transportation Alliance bank is a wholly owned subsidiary of Flying J Inc, a Utah Corporation headquartered in Ogden, Utah. Flying J is the 17th largest privately held company in the U.S. with sales of $ 15 billion and is best known for its "Cadillac" nationwide network hospitality and fueling Travel Plazas located on Interstate highways and in 40 states in the U.S. and 7 provinces in Canada.

I have been involved in business in North America for over 25 years, have held senior management position in a number of Companies and have been the President of Transportation Alliance Bank for the last over four years.

I would like to use my limited time today to clarify some of the issues relating to industrial banks and provide an accurate context to understand this market driven, healthy, safe and sound industry that many people think is the best model for all banks in the current economy.

The story of Transportation Alliance Bank can best be told by first talking about the Industry and Customers it exclusively serves – The Trucking Industry – , why it serves this industry and the critical role the Trucking Industry plays in the economy of the United States.

With as many as three-quarters of a million interstate motor carriers in the U.S., the trucking industry is the driving force behind the nation's economy. Trucking does the heavy lifting to move, at some point in the supply chain, nearly everything consumed in our modern society. Few Americans realize that trucks deliver nearly 70 percent of all freight tonnage or that 80 percent of U.S. communities receive their goods exclusively by truck. Even fewer are aware of the significant employment, personal income, and tax revenue generated by the motor carrier industry.

It takes nearly nine million people to move approximately 11 billion tons of freight annually. Trucking generates approximately $625 billion in revenue and represents roughly five percent of U.S. Gross Domestic Product. One out of every 13 people working in the private sector in the U.S. is employed in a trucking-related job, with these jobs ranging across the manufacturing, retail, public utility, construction,

service, transportation, mining and agricultural sectors. Of those employed in private-sector trucking-related jobs, 3.4 million are commercial drivers.

The trucking industry is composed of both large national enterprises as well as a host of small businesses, all of whom operate in extremely competitive business environments with narrow profit margins. According to the U.S. Department of transportation 91 percent of motor carriers have 20 or fewer trucks and are classified as small businesses.

The story of Transportation Alliance Bank is intricately premised on the fact that the key engine of the trucking industry is primarily the entrepreneurs with 20 of less trucks and the fact that Flying J and, therefore, Transportation Alliance Bank better understands the business, business risks and how to mitigate these risks of these trucking company entrepreneurs better than any other mainstream national, regional or community banks.

The CEO of Flying J Inc., Phil Adams, fully recognized this nature of the trucking Industry and the fact that mainstream banks did not readily finance these small trucking companies and, therefore, trucking was being undercapitalized. Transportation Alliance Bank was organized in 1998 to fill this banking services void to an underserved business community that is key to our economy This was possible only because we could obtain an Industrial Bank Charter in our home State of Utah.

The services we provide is best expressed in a typical testimonial letter we recently received. The name of this customer is Sierra Trucking. It is owned by Gregory Arthur who hails from typical small town America, Mt. Gilead, Ohio., population:

2,840. His sentiments are expressed as follows:

"....... I want to talk about Transportation Alliance Bank's helping hand in starting a trucking company and continuing to be there with financing when other "mainstream banks" who do not understand the trucking industry (at least at my level), slammed the door on many requests for financing.

I had worked over the years for a few small outfits and in the process gathered data on the specific truck I was driving. In turn I created financial statements. I accumulated these over a few years and created an overview of what I could do if I had my own trucking company. I took these projected financial statements to a number of "mainstream banks but they would not give me any serious consideration. I had the numbers, had the experience in trucking, had the drive to give 110% to make the business work but no one would give me a chance.

So as fate would have it, I was working for a company that was going under. I knew they were going to declare bankruptcy and that equipment could be repossessed and thought this may be an opportunity to get started in my own business, This is when I met Steve Parker from Transportation Alliance Bank. If it was not for Steve, this story would end here. Transportation Alliance Bank looked at all the data I had and decided to give me a chance.

Steve and TAB allowed gave me a loan on the equipment and together with them I am still in business four years later with a production of revenue close to $ 500,000 and which goes right back in the economy.

Another great service Transportation Alliance Bank has provided and that is essential for me to stay in business is their factoring program. This provided me

working capital funds to operate my business. Also, they have a way to run credit checks on people I haul for and also have them with collections if a company if a Company is past due on my settlement

In closing, Steve Parker and Transportation Alliance Bank took and risk and gave me a chance. I have been able to stay in business, earn a decent living put money back in the economy. Most of all I can take care of my family and provide relief to Hurricanes Ivan, Jean, Dennis and Katrina. Finally by Transportation Alliance Bank giving me a chance, motivated me and kept me going and my quality of life is better than it ever has been"

Thanks to the Industrial Bank Charter, Transportation Alliance Bank has been in business for nine years, with an asset base of approx. $500 million and providing a whole host of banking services to the Trucking Industry ranging from receivables factoring, equipment financing to debit and credit cards. It makes CRA investments in the local community and its efforts in this area have been rated highly by regulators. It is a very safe and sound bank serving primarily the needs of drivers, independent Owner Operators and small trucking Company entrepreneurs from small town America and, in my opinion, better than anybody else

I contend this is also true of industrial banks in Utah and which are demonstrably among the strongest and safest banks in the nation today and have been so for some time. Utah banks have the highest aggregate capital and profit ratios in the nation. This record is not a fluke. The industry in Utah has grown to $200 billion in assets over more than 20 years and established a record of safe and sound operations comparable to any other banks insured by the FDIC. This is not attributable to Utah's robust economy

since virtually all Utah based industrial banks serve customers nationwide and do most of their business outside of Utah. When the principal goal of the regulatory system is to help ensure the safety and soundness of banks and the banking system, it makes no sense to do anything that would undermine the strongest and safest banks.

There is no deficiency in the regulation of these banks or their holding companies. Regulation of industrial banks is equal to, and in some respects stronger than, the regulation of all other depository institutions. There is also extensive and effective regulation of the holding companies and affiliates. An industrial bank's regulators have the authority to examine affiliates, issue cease and desist orders, assess civil money penalties, remove officials, and force divestiture of the bank if necessary. In fact, and consistent with premise, Flying J Inc. has recently been contacted so that regulators can audit the holding company of Transportation Alliance Bank

Nor is it the case that traditional holding company regulation provides better protection for a bank subsidiary. In reality, most traditional bank holding companies provide little support to their subsidiary banks. In my opinion most traditional holding companies provide only minimal support to their banks and are essentially irrelevant if a bank is failing. Also, traditional bank holding company regulation is outdated because it is no longer needed to accomplish its primary goal, which is to ensure equal access to credit, and is a model for weak holding companies that is increasingly in conflict with the financial services industry and the nation's economy.

In contrast, diversified holding companies usually provide a higher level of support to their bank subsidiaries. Just like Flying J Inc., diversified parents tend to be

much larger than the bank and provide extensive financial support as I evidence first-hand with Flying J Inc. For most industrial banks, capital is simply not an issue. They can get whatever capital they need whenever they need it. The same cannot be said for most bank holding companies, especially if a bank is failing. Diversified parents like Flying J Inc., also typically provide the bank with an established business so the bank has few or no marketing costs and is profitable from the outset.

Finally, I would like to briefly discuss the separation of banking and commerce. Flying J has private tanker truck fleet of 800 tractors; one of the largest private fleet for hauling bulk fuel in the country. Consistent with the requirements of Sections 23A and 23 B that strictly control transactions with affiliates, Transportation Alliance Bank does not finance any assets of the Flying J private fleet and all such funding is obtained by Flying J through third party banks. Also, any products purchased by Transportation Alliance Bank Credit Card customers at Flying J facilities is not funded by Transportation Alliance. In my humble opinion, there is no evidence of any inherent structural risk in allowing banks to be owned by companies that engage in activities other than banking as long as the banks do not directly finance its affiliates. I have heard comments that if industrial banks continue to develop the Fortune 500 will all eventually finance their operations through captive banks. This is a misconception. No one I am aware of is arguing for allowing companies to finance their operations with federally insured deposits. The moral hazard is obvious and unacceptable and is already effectively prohibited by Sections 23A and 23B of the Federal Reserve Act. Those laws, and their strict enforcement of it by the FDIC and the State Banking

regulators strictly limit transactions between a bank and its affiliates and ensure that affiliate transactions pose no risk to the bank.

Activities restrictions on holding companies are the crux of this issue. The real public policy underlying that doctrine is credit availability. The separation of banking and commerce began when banks were the primary providers of credit and needed to be separate so all businesses had equal access to credit. But the economy has fundamentally changed during the past thirty years. One of the defining characteristics of today's economy is the development of credit and financial services by all kinds of businesses. The U.S. economy has become the most prolific producer of credit that ever existed. Companies operating outside the traditional bank holding company structure may now provide most of the credit in the economy. Many of those companies want access to a depository charter because it enables them to provide their financial services more efficiently and cost effectively. That is what has caused the dramatic growth of the industrial banks over the past twenty years. It has also eliminated the issue of credit availability. (If anything, the issue today is whether credit availability has become too available, as the current subprime mortgage crisis illustrates.)

If you peel away all of the political rhetoric the real issue regarding industrial banks is whether the large number of competent and legitimate businesses in our nation that offer bank quality products and services will be allowed to operate in the most efficient and profitable manner, providing superior value to its customers in a safe and sound manner. That really is the whole issue.

With that I will close and would be glad to respond to any questions. Thank you.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM EDWARD LEARY

Q.1. What purposes do ILCs serve that cannot be adequately served by other banking or non-banking entities?

A.1. ILCs serve a wide variety of purposes that are not adequately served by other banking or non-banking entities. If the purposes for which ILCs exist were being adequately served, they would not exist; because the owners of these ILCs would not perceive a benefit for themselves or their customers to invest capital into an already efficient and effective market. Due to the niche or emerging products and services provided by many ILCs, existing traditional banking and non-banking entities may not service these markets adequately. Where traditional banking and non-banking entities compete to supply consumers with similar products and services, consumers are given better pricing, better customer service, and more choices.

Q.2. A 2006 report from the FDIC's Office of Inspector General detailed the widespread use of non-standard conditions in granting deposit insurance. The State of Utah also includes certain conditions in its orders approving new ILC charters.

- Is there any question regarding the enforceability of these conditions in a legal context?
- Could the FDIC simply withdraw its deposit insurance if the ILC does not honor the conditions?

A.2. The enforceability of conditions included in orders issued by the Utah Department of Financial Institutions has not been challenged by an institution in a court of law. In practice for many decades, conditions, statutes, and rules are usually cited in the Report of Examination as apparent violations of the respective statute or rule. As a result of the institution's non-compliance with a condition of an order, statute, or rule, an informal or formal action may be brought against the institution. These remedial actions range in severity from a Board Resolution, Memorandum of Understanding, and Written Agreement, to a Cease and Desist Order. Non-compliance with administrative actions could result in removal of the offending officer and/or revocation of the charter.

The FDIC could withdraw its deposit insurance under the authority granted them by 8(g) of the FDI Act. The statutory authority of the Federal banking agencies changed with the enactment on October 13, 2006 of the Financial Services Regulatory Relief Act of 2006, which provides that notwithstanding the provisions of 12 U.S.C. § 1818(b)(6)(a), the appropriate Federal banking agency may enforce any condition imposed in writing by the agency on an institution-affiliated party ("IAP") in connection with any action on any application, notice, or other request concerning the depository institution or in connection with any written agreement entered into between the agency and an IAP. 12 U.S.C. § 1831aa. This amendment provides "discretionary authority" to the Federal banking agencies "to enforce (1) any condition imposed in writing in connection with any action on any application, notice, or other request, or (2) any written agreement between the agency and an IAP. S. Rep. No. 109–256, 109th Cong., 2d Sess. (2006) (emphasis added).

Q.3. Is the key issue in the ILC debate the commercial ownership of a banking charter or the commercial ownership of a Federally-insured entity?

A.3. In Utah these key issues are not mutually exclusive. Utah law requires all depository institutions to be federally insured. For the purposes of this question, the key issue in the ILC debate on commercial ownership of a Federally-insured, state chartered ILC appears to be an argument against a commercially owned ILC that has Federal Deposit Insurance. As argued by some, an ILC owned by a commercial entity may extend the FDIC safety net over not only the insured depository institutional, but also its commercial parent and affiliates and their activities. This argument disregards twenty years of operational experience and existing federal regulations preventing the mixing of banking operations and parent company activities whether commercial or not. Regulation W implements Sections 23A and 23B of the Federal Reserve Act, which imposes quantitative and qualitative limits on the ability of a bank to extend credit to, or engage in certain other transactions with, an affiliate. The history of Utah ILCs has been strict compliance with these provisions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM EDWARD LEARY

Q.1. As I said in the opening statement, I am hearing a lot of praise about Britain's approach to regulation as a model for an effective but not onerous system to oversee banks, brokers and investment funds, and one that could improve the competitive position of U.S. financial markets globally. When was the last time Congress did a thorough evaluation of our financial services regulatory structure answering these types of questions?

- Does our financial services regulatory structure correspond to the needs and problems? (Relevance)
- Does our financial services regulatory structure achieve its objectives? (Effectiveness)
- Does our financial services regulatory structure achieve its objectives at reasonable costs? (Efficiency/cost-effectiveness)

A.1. A state bank regulatory perspective of our financial services regulatory structure has indicated a historic and continuing support of the "Dual Banking System." An adoption of an FSA like model would eliminate that system of checks and balances that has provided strength and vitality to our banking system. Reference is made to the response of the Conference of State Bank Supervisors dated November 30, 2007 to the Department of the Treasury study of the, "Review of the Regulatory Structure Associated with Financial Institutions," which outlines the state view on the FSA Model and other related issues. The hallmark of state regulation has always been the closeness of state regulators to the people and a deeper and better understanding of local markets and sensitivities. The pillars of safety and soundness, consumer protection, consumer compliance and community reinvestment are best enforced at a local level. As an example, recently the Office of the Comptroller of the Currency joined together with several states by signing a

Memorandum of Understanding to institute a consumer complaint resolution process that begins at the local level. Despite the fact that national banks are not regulated by the state bank regulators, they have joined forces with the Comptroller of the Currency's Office to help consumers at a local level get answers to their complaints in an expedited manner.

Does our financial services regulatory structure achieve its objectives? Yes, I believe bank regulators strive to achieve their objectives, but we can always improve. The dual banking system puts pressure on state and federal regulators agencies to be the best they can be. Because institutions have a choice of charters, national or state, they have a choice in their regulatory agencies.

Our financial services regulatory structure achieves its objectives at reasonable costs because as stated above if they don't, institutions will migrate to a more efficient, effective regulatory structure.

One area that the financial services regulatory structure could improve that Utah has observed first hand from our inspections of financial institution holding companies is in the coordination of regulatory activities between state and federal regulatory agencies involved with a common parent company. The coordination of regulatory activities between regulatory agencies would be a small step toward Britain's approach without dismantling a very successful and stable model here in the United States. Also, efficiencies could be gained by having shared or common legal functions at the Federal Agencies. Currently, each agency has a staff of attorneys that develop, interpret, and apply federal law for each separate agency. These attorneys also spend a fair amount of time evaluating other agencys' opinions at the federal statutory level. Differences of opinions between the agencies can lead to differences in treatment and cause institutions to convert charters, thus allowing federal regulatory agencies to gain an advantage in the marketplace.

Q.2. It is my understanding that Financial Services Authority in the United Kingdom not only requires cost-benefit analysis for proposals before going forward, but it is required to report annually on its cost relative to the costs of regulations in other countries. How does this contrast with our system?

A.2. Utah would consider this question more appropriately directed to our federal agency counterparts.

Q.3. I am very appreciative of all the hard work and cooperation of your agencies in reviewing and preparing a matrix of all the regulatory relief recommendations and positions for this committee. In order to get this legislation signed into law, all sides compromised and didn't let the perfect stand in the way of what was possible. I would appreciate if each agency would get back to me and the Banking Committee with a list of their top two or three priorities from this list that would meaningfully reduce regulatory burden for institutions they regulate.

A.3. Utah would consider this question more appropriately directed to our federal agency counterparts.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM BRIGID KELLY

Q.1. Is there a tension between our dual banking system and our desire to ensure a level playing field for all participants? In other words, in our effort to eliminate competitive inequities, do we run the risk of stifling both the dual banking system and the innovation that is spawns?

A.1. The issue for the UFCW with respect to ILCs has never been the question of a level competitive playing field. The UFCW represents more than 1.1 million individual members and their families throughout the nation. UFCW Local 1099 represents almost 20,000 people in Ohio and Kentucky. Our members are consumers and workers who have a strong interest in the safety and soundness of their banking system and want to ensure that they and their funds are protected by appropriate regulation.

What is important to UFCW members is less the theory regarding the innovation spawned by the dual banking system, than about the nuts-and-bolts, nickkel-and-dime impact on America's working families. The UFCW favors innovative regulatory protections that states put in place—both in the banking system and in other areas of regulation.

However, there must be a basic floor of regulation. The problem with the ILC system is that ILCs skirt the floor of regulation that has been put in place to govern all other companies that own banks. In fact, the ILCs represent a loophole in the dual banking system or a little known third banking system. This third system both does away with the necessary safety and soundness regulation at the holding company level that the Federal Reserve administers for other state and federal bank holding companies and it allows for ownership of these banks by commercial companies which is not allowed for other state and federal banks. For this third system, or loophole, to be the means through which these significant policy protections are jettisoned does not make sense.

The real question here, then, is not whether there should be a single level playing field that does away with the dual banking system but whether we should continue to have a third banking system that only exists in a few states and does so without some of the most fundamental protections that have made our banking system strong. We believe the current system does not make sense and that we should have legislation to close the ILC loophole.

Q.2. When the Congress eliminated new nonbank banks and unitary thrift holding companies in the Competitive Equality Banking Act and Gramm-Leach-Bliley Act, it permitted many of these entities to remain in existence under grandfather provisions.

If the Congress did prohibit commercial ownership of ILCs based on safety and soundness concerns, would it not create competitive inequities to grandfather existing ILCs?

To take just a single example from the automotive industry: BMW, Volkswagen and Toyota own ILCs; should Chrysler be denied an ILC?

A.2. Grandfathering can create competitive inequities, but this is often how Congress chooses to make changes like it did in CEBA and GLBA because ending an ongoing concern is seen as a draco-

nian response. The best policy from the UFCW's perspective would be simply to make all ILCs subject to the Bank Holding Company Act and not worry about grandfathering. At the same time, we recognize that this may be seen as unfair by current ILCs that have established themselves under the rules that have been in place to date.

Whether the Committee decides to have a grandfathering provision or not, however, that question should not stop the implementation of necessary reform. The ILC loophole does not make sense and it puts consumers, businesses, FDIC insurance and the banking system at risk. We have seen an explosion of interest in ILC charters from commercial companies and the Congress's failure to act will—without a doubt—result in additional ILC applications.

Q.3. The Gramm-Leach-Bliley Act defines activities that are financial in nature. The National Bank Act permits activities that are part of or incidential to the business of banking. The Fed recently determined that WellPoint's disease management and mail-order pharmacy activities are complementary to a financial activity. In attempting to distinguish between banking and commercial activities, where would you draw a line that is both appropriate and consistent with current laws?

A.3. The UFCW has never taken a position on precisely where the line between commerce and banking should be drawn for the purposes of determining the complementary activities in which banks should be allowed to engage and we are not ready to do so at this point. We may differ with the Federal Reserve at times when it makes individual decisions about permissible complementary activities, but we strongly believe that the Federal Reserve must make such decisions to avoid the profound problems associated with the unfettered mixing of banking and commerce. Currently, there is no check on the degree to which commerce and banking mix through the use of ILC charters. That is an untenable situation that must end. With that in mind, the UFCW is quite willing to place the line-drawing authority in the hands of the regulatory authorities at the Federal Reserve and the FDIC.

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

SENATOR E.J. "JAKE" GARN
1031 North Chartwell Court
Salt Lake City, Utah 84103

November 12, 2007

The Honorable Christopher J. Dodd
Chairman, Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Re: October 4, 2007 Hearing on Industrial Loan Corporations in the 1987 Act

Dear Mr. ~~Chairman~~ CHRIS,

You are to be commended for your efforts in trying to shed some light on Industrial Loan Corporations, their origins, their safety and the role these financial institutions play in the modern American economy. By focusing the October 4, 2007 hearing on the Industrial Bank charter, and not specific legislation, discussions were fruitful and fact-based. Those of us involved in the banking environment appreciate your contribution to the deliberative process.

During the hearing a number of inaccurate statements and misrepresentations were made by several witnesses regarding the history of industrial loan corporations and the exemption contained in the Competitive Equality Banking Act ("CEBA") of 1987. As a member of the United States Senate Banking Committee from 1974 to 1993, I was intimately involved in the drafting of CEBA. The purpose of this letter is to provide my eyewitness view of our original intent, and to clarify some of the erroneous statements made during the hearing. As no other individual can, I offer the following facts:

- CEBA was an attempt to provide clarity and direction to developments taking place in the banking industry and the nation's financial services markets at that time. For several years, nontraditional banks such as industrial banks and "nonbank banks" had grown significantly. It was clear that these developments had strong and growing support in the markets but they were occurring outside of the scope of the laws that existed then and Congress wanted to examine those institutions and bring them under express legal and regulatory provisions. I helped lead these efforts in my role as chairman of the Committee from 1981 to 1986 and as the ranking Republican member thereafter until my retirement in 1993.

- Several Senators on the Banking Committee in 1987 represented states that had chartered industrial loan corporations and believed the continuing development of ILCs should not be restrained by federal law. This included Senators from both sides of the aisle such as Senator Cranston of California and Senator Armstrong of Colorado.

- This bipartisan group also felt that ILCs should be federally insured if they continued to develop as depository institutions. I had been involved in drafting legislation enacted by Congress in 1982 that made ILCs eligible for federal deposit insurance and I was aware that several states had subsequently amended their laws to require depository ILCs to have federal deposit insurance. I thought it was prudent to make federal deposit insurance a requirement for every bank operating under the ILC exemption from the Bank Holding Company Act and supported adding that provision to CEBA.

- Both the Senate and House committees were fully aware that passage of CEBA would allow companies to acquire control of ILCs that would not be permitted to control a commercial bank due to the activity and geographic restrictions in the Bank Holding Company Act, and that many of those ILCs would serve customers nationwide. The Federal Reserve advocated closing what it termed that "loophole". The industry lobbied to demonstrate that it played a safe and valuable role in the financial services markets. Congress decided to allow ILCs to continue in the states where they were already established and under the same legal and regulatory restrictions and standards applicable to all other banks to ensure their safety and avoid competitive imbalances. We felt this was a balanced solution that responded to the strong market demand for this type of charter, which fills an important need.

- I was satisfied that allowing commercial companies to own an ILC would not pose a risk to the bank or the banking system. The FDIC published a study the same year CEBA was enacted that found no basis for restricting commercial ownership of banks and recommended the complete repeal of the Bank Holding Company Act. CEBA stopped far short of that recommendation. In addition, the members of the Committee believed that additional holding company oversight was not needed because extensive oversight of industrial bank holding companies was already provided under existing laws and other laws effectively control potential conflicts of interest, including Sections 23A and 23B of the Federal Reserve Act and the anti-tying provisions of the Bank Holding Company Act. The accumulated record of safe and sound operations by industrial banks over the past twenty years has proven my view correct.

- I don't recall the growth of ILCs being an important issue when Congress enacted CEBA and I don't think Congress would have changed CEBA if it had. We understood at the time that ILCs were developing into innovative providers of both consumer and commercial financial services and saw no reason to restrict

that development if the ILCs operated under the same safety and soundness standards as other banks. I am pleased that Congress provided that opportunity because it turned out to be a very successful regulatory structure. That is evidenced by the fact that the ILCs in Utah, for example, are the safest and strongest group of banks in the nation.

- The facts simply do not support the claims during the recent hearing that industrial bank holding companies lack proper supervision and that that constitutes a "regulatory blind spot". The question today is the same as in 1987: what amount of regulatory oversight of holding companies and affiliates is needed? Is the more focused and coordinated "bank centric" model used for industrial banks too little? Or is the less coordinated traditional bank holding company model too much? We had less of a record to guide us in 1987 but we knew we were not leaving industrial bank holding companies and affiliates unregulated. In fact, the FDIC was saying at the time that existing laws would be adequate to properly regulate federally insured banks and their affiliates if the Bank Holding Company Act was repealed. The accumulated record since then provides no evidence of any deficiencies in the bank centric model. If anything, the bank centric model has proven to be stronger and more effective than the traditional holding company model.

- Since retiring from Congress and returning to private life, I have seen the benefits of the bank centric model firsthand. A typical bank holding company is little more than a shell organized to hold the bank's stock. It can do little to support the bank, especially if the bank is failing. Those of us who had to deal with the collapse of the savings and loan industry and the near bankruptcy of the FDIC in the 1980s and 90s know how incapable most holding companies were of dealing with a failing bank or thrift. The "source of strength doctrine" touted by the Federal Reserve is actually just a policy of not allowing the holding company to do things that might weaken or create risks for the bank. That is good as far as it goes but it does not provide any significant support for the bank. In contrast, I serve as a director on the boards of two industrial banks owned by commercial parents and those banks enjoy a level of financial and marketing support from the parent companies that far surpass any support from parents of traditional banks. Capital is simply not an issue for industrial banks. They have access to whatever capital they need whenever they need it. In an industry where "capital is king", this advantage is remarkably underappreciated. And these banks have little or no marketing expense. They were organized to provide a more efficient way to conduct a business that had already been developed. That does not include providing any financing to the parent or affiliates. The banks' regulators have encountered no impediments to examining and regulating the banks and their parents and affiliates. These are safe and sound operations and are less likely to fail than other banks.

I hope these facts will assist you and the other members of the committee to see the increasingly important role industrial banks play in the modern financial services markets. It is now clear that Congress's decision to enact CEBA and with it to craft the regulatory structure for industrial banks has proven very successful. Industrial Banks are among the strongest financial institutions in the country. They are delivering creative and innovative financial services to millions of American consumers and businesses. They are filling niches that the market has demanded for two decades. In my own view, this success has proven that the regulatory model this represents must now be seriously considered as a better option for all banks.

I am happy to respond to the questions or requests for information you may have about these or any other matters.

Sincerely,

E.J. "Jake" Garn
United States Senate, Retired