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Statement of

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before the

Committee on Banking, Housing, and Urban Affairs

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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]

[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.

[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.