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Statement of

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Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

House of Representatives

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Chairman Frank, Ranking Member Bachus, 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) and H.R. 698, the Industrial Bank Holding Company Act of 2007. 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. 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 for Congress to 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. If left unchecked, this recent and potential future growth of firms operating under the exception threatens to undermine the decisions that Congress has made concerning the separation of banking and commerce in the American economy and the proper supervisory framework for companies that own a federally insured bank. The ILC exception also creates an unlevel competitive playing field by allowing both financial and commercial firms to own an insured bank but avoid the prudential limitations,

supervisory framework and restrictions on affiliations that apply to corporate owners of other insured banks.

The Board appreciates the steps that the Federal Deposit Insurance Corporation (FDIC) recently has taken regarding ILCs. These include extending the temporary moratorium on the acquisition of ILCs by commercial firms and seeking ways to help address the supervisory gaps caused by the ILC exception. However, only Congress can craft a solution that addresses the full range of issues created by the ILC exception in current law in a permanent, comprehensive and equitable manner. Your decisions on these matters, whether by action or inaction, also will influence the structure, soundness and resiliency of our financial system and economy. As I will discuss, 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 going forward. 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. H.R. 698 would narrow, but not close, this loophole.

The ILC Exception and Its Origins

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. And second, the act prevents bank holding companies from engaging in general commercial activities and allows bank holding companies that qualify as financial holding companies to engage only in those 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.[1]

The ILC exception allows a company to acquire an insured bank chartered in one of a handful of states--principally Utah and California--without becoming a bank holding company under the BHC Act and without abiding by the supervisory and regulatory framework established under that act. Ironically, the special exception for ILCs was enacted in 1987 as part of a broader legislative package designed to *close* an earlier loophole--the so-called nonbank bank loophole--that increasingly was being exploited by large commercial and financial firms to evade the nonbanking restrictions and consolidated supervisory requirements of the BHC Act. In 1987, Congress acted affirmatively to close this loophole by passing the Competitive Equality Banking Act (CEBA). That act expanded the definition of "bank" in the BHC Act to include any FDIC-insured bank (regardless of the activities it conducts) *and* any banking institution that both offers transaction accounts and makes commercial loans (regardless of whether it is FDIC-insured). Importantly, the act also provided that, subject to certain limited exceptions, any company that acquired an institution meeting this expanded definition of "bank" would be subject to the same activity restrictions and supervisory and regulatory framework as other bank holding companies, including the prohibition on engaging in commercial activities.

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[1] Bank holding companies that do not qualify to be a financial holding company under the GLB Act are permitted to engage in a smaller range of activities that have been found to be "closely related to banking."

One of the exceptions adopted in CEBA was for ILCs chartered in those few states that, as of March 5, 1987, had in effect or under legislative consideration a law requiring ILCs to have FDIC insurance. At the time, the size, nature and powers of ILCs were quite restricted. ILCs were first established in the early 1900s to make small loans to industrial workers. For many years, they were not generally permitted to accept deposits or obtain FDIC insurance. In fact, at the time CEBA was enacted, most ILCs were small, locally owned institutions that had only limited deposit-taking and lending powers under state law. 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 also were not actively chartering new ILCs. At the time CEBA was enacted, for example, Utah had only eleven state-chartered ILCs and had a moratorium on the chartering of new ILCs. Moreover, interstate banking restrictions and technological limitations made it difficult for institutions chartered in a grandfathered 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 a federally insured bank 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 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 Utah-chartered ILCs also has doubled since 1997, while declining in the few other states permitted to charter exempt ILCs.

The nature and size of individual ILCs and their parent companies also has changed dramatically in recent years. While the largest ILC in 1987 had assets of approximately $410 million, the largest ILC today has more than $67 *billion* in assets and more than $54 *billion* in deposits, making 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 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 impressive, 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 limited restrictions on the types of activities that an ILC may conduct. For example, ILCs may operate under the exception so long as they do not accept demand deposits that the depositor may

withdraw by check or similar means for payment to third parties. Nevertheless, some ILCs engage in retail banking activities by offering retail customers negotiable order of withdrawal (NOW) accounts--transaction accounts that are functionally indistinguishable from demand deposit accounts. In addition, federal law allows new or existing ILCs of any size to collect FDIC-insured savings or time deposits from institutional or retail customers and offer 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, consolidated supervision and regulatory framework that apply to other community-based, regional and diversified organizations that own a bank. Addressing these matters will only become more difficult if additional companies are permitted to acquire ILCs and operate under a different supervisory and regulatory regime than the owners of other insured banks. Let me discuss these

points in more detail and comment on how these matters would be addressed under H.R. 698, the Industrial Bank Holding Company Act of 2007, as introduced.

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 banking and commercial firms under the auspices of a single holding company. And, as noted earlier, when the 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

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[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.

The ILC exception, however, has allowed several large commercial firms to acquire an insured ILC and additional commercial firms currently have ILC acquisition proposals pending before the FDIC. H.R. 698 would narrow, but not eliminate, the potential for further mixing of banking and commerce through the ILC exception. Importantly, 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. This 15 percent commercial "basket" is quite sizable and potentially would allow new firms that acquire an ILC to have significant commercial holdings. A large U.S. financial firm potentially could meet the 15 percent test in H.R. 698 even if it owned a commercial company the size of, for example, Kohl's, U.S. Steel, Waste Management, Office Depot or Nike.

No similar commercial "basket" exists for bank or financial holding companies, which generally are prohibited from engaging in commercial activities under the GLB Act. 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]

It also is unclear what activities would be considered "commercial" or "financial" for ILC owners under H.R. 698. 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"

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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.

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 H.R. 698, but that would be considered commercial under the GLB Act.

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. 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. We believe it is important that Congress, as it has in the past, set the nation's policies with respect to the proper mixing of banking and commerce and consider carefully and deliberately whether any changes to the nation's policies on this important issue should be made. Once these decisions are made, we see no reason to generally exempt the owners of insured ILCs from the policies established by Congress: these policies should be applied to all owners of 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 banks to affiliate with firms that are purely financial. 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 Community Reinvestment Act (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. H.R. 698 does not address this significant regulatory disparity.

Consolidated Supervision. The ILC exception also undermines the supervisory framework that Congress has established for the corporate owners of insured banks. 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. Large organizations also 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 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

[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.

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 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.

H.R. 698 takes an important step by recognizing that the potential lack of consolidated supervision of the parent and nonbank affiliates of an ILC creates special risks that should be addressed. The bill currently seeks to address these risks by granting the FDIC new supervisory authority for the existing and future corporate owners of ILCs (other than those that are already subject to consolidated supervision by a federal banking agency) that is similar to the authority that the Federal Reserve has with respect to bank holding companies. The Board strongly supports efforts to ensure that the existing corporate owners of ILCs are subject to consolidated supervision by a federal agency that has the same tools as the Federal Reserve to help protect the safety and soundness of insured banks and the federal safety net that supports those banks.

These tools include the ability to ensure that the holding company for an industrial bank acts as a source of strength for the bank. As I will discuss later, however, the Board also strongly believes that the ILC exception should be closed to new owners of ILCs.

Foreign Banks. In addition to constructing a consolidated supervisory framework for domestic banking organizations, Congress has made this type of supervisory framework 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 foreign banks demonstrate that they are subject to comprehensive supervision on a consolidated basis in their home country before acquiring a U.S. bank or establishing 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. This gap in current law needs to be addressed.

Fair Competition and Other Issues. The differences 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. H.R. 698 would perpetuate these competitive imbalances by continuing to grant firms that acquire an ILC significant advantages not available to the owners of other insured banks, such as the authority to engage in commercial activities and the ability to escape the CRA, capital and managerial requirements that apply to financial holding companies. These advantages will

provide incentives for firms to continue to exploit the exception. These differences also create the opportunity for firms to engage in "regulatory arbitrage" and, over time, may 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.

Moving Forward

The Board believes the best way to 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 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 H.R. 698 and on the many important issues presented by 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.