Statement of
Sheila C. Bair, Chairman,
Federal Deposit Insurance Corporation
On H.R. 698,
The Industrial Bank Holding Company Act of 2007
before the
Committee On Financial Services
U.S. House of Representatives
Room 2128, Rayburn House Office Building
April 25, 2007

Chairman Frank, Ranking Member Bachus 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. Recently, 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 will become subsidiaries of companies engaged in non-financial activities, i.e., commercial activities.2 This moratorium extension will allow the FDIC to carefully weigh the safety and soundness 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. Finally, I will discuss possible enhancements to H.R. 698, the Industrial Bank Holding Company Act of 2007.

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. Many 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.

As of January 31, 2007, there were 58 insured ILCs, with 45 based in Utah and California. ILCs also operate in Colorado, Hawaii, Indiana, Minnesota and Nevada. Because the powers of the ILC charter are determined by the laws of the chartering state, the authority granted to an 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, accounting for less than one percent of the almost 8,700 insured depository institutions and approximately 1.8

percent of industry assets. Attachment 1 provides a list of operating ILCs with their asset and deposit data as of December 31, 2006.

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 year-end 2006, total ILC assets grew from approximately $12 billion to $213 billion. More than 60 percent of that growth is attributable to a small number of financial services firms (see Attachment 2).

Of the 58 existing ILCs, 43 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 43 ILCs represent approximately 85 percent of the ILC industry's assets and 89 percent of the ILC industry's deposits as of December 31, 2006. 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 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.

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. Under this kind of ownership model, consolidated supervision would generally not be present, 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 will allow 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 will take no 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 will proceed with action on, any application for deposit insurance or any change in control notice 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.

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.6 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 is seeking comment on whether those issues can be controlled or minimized through existing regulatory authority. Specifically, the FDIC is proposing additional safeguards that provide adequate protections for the safety and soundness of the insured ILCs and for the protection of the Deposit Insurance Fund.

The FDIC has 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 will consider, 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 that 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 or preventing 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.7 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 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 will consider 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.

H.R. 698, the Industrial Bank Holding Company Act of 2007

The FDIC strongly supports efforts to provide statutory guidance on the key issues regarding the ILC charter, especially the issue of commercial ownership. As I discussed earlier in my testimony, many of the issues surrounding ILC ownership involve important public policy considerations that should be resolved by Congress. Although the FDIC is not endorsing any particular legislative approach to resolving ILC issues, H.R. 698, the Industrial Bank Holding Company Act of 2007 provides a workable framework for the supervision of ILCs and their holding companies.

In reviewing H.R. 698, the FDIC did not consider the issues regarding the appropriate levels of commercial activities, preferring to leave this fundamental issue to the legislative process for resolution. However, the FDIC did identify some concepts that would improve and strengthen the bill with regard to the supervision of ILC holding companies.

H.R. 698 would expressly provide the FDIC with several important supervisory authorities with respect to ILC holding companies. For example, the bill would provide the FDIC with the express authority to examine the holding company and each subsidiary of the holding company to substantially the same extent that the FRB may examine bank holding companies and their subsidiaries. Likewise it provides comparable authority to require reports and recordkeeping.

Other provisions of H.R. 698 are not comparable to the supervisory tools provided to the FRB with respect to bank holding companies. For example, the FDIC should have the same express authority as the FRB to impose consolidated capital requirements on the holding company. Capital is a critical pillar of the safety and soundness of our insured institutions, and the authority to require a certain minimum level of consolidated capital would help ensure that a holding company serves as a source of strength for the insured institution.

With the addition of authority to impose consolidated capital requirements and other authorities of the Bank Holding Company Act, H.R. 698 would provide the FDIC with supervisory powers over ILC holding companies that are comparable to the FRB's powers over bank holding companies. This improved statutory framework should provide the FDIC with the tools to effectively supervise ILC holding companies.

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. Many 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 in the coming year.

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

---

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 intends to follow the guidance of the FRB and OTS in its interpretations of the term "financial activity" and to consult with the FRB and/or OTS before making any decisions.

3 Bank Holding Company Act section 2(c)(2)(H), 12 U.S.C. 1841(c)(2)(H).

4 Government Accountability Office (GAO), Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority, September 2005, p. 24.

5 See Industrial Loan Companies and Industrial Banks, 71 FR 49456 (August 23, 2006).

6 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).

7 While some of the chartering states do have supervisory authority over companies that control industrial bank subsidiaries that is not true of all of the states that charter industrial banks.

Last Updated 4/25/2007