BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

June 25, 2003

The Honorable Tim Johnson
United States Senate
Washington, D.C. 20510

Dear Senator:

I am writing in response to your request for the Board's views on several questions related to the federal supervision of insured industrial loan companies (ILCs). As you know, a special exemption under federal law permits any type of firm, including a commercial or retail organization, to own an insured ILC and operate it without being subject to the type of consolidated supervision and restrictions generally applied to the corporate owners of insured banks.

Your letter highlights the important public policy issues that are raised by proposals that would expand the powers of ILCs operating under this special exemption by authorizing these institutions to offer business checking accounts and open *de novo* branches nationwide. The Board has opposed these expansions of ILC powers because they are inconsistent with the basis on which the exception for ILCs was granted--that they were limited-purpose institutions. Granting ILCs essentially full banking powers while allowing their corporate owners to retain their special exception would be contrary to the nation's policies of maintaining the separation of banking and commerce and requiring the consolidated supervision of companies that own full-service insured banks.

Responses to the specific questions posed in your letter are enclosed. I hope this information is helpful.

Sincerely,

Enclosure

1. Why is consolidated supervision important to the safety and soundness of insured banks and the stability of the U.S. financial system?

Consolidated supervision is a supervisory framework that provides a supervisor the tools needed--such as reporting, examination, capital and enforcement authority--to understand, monitor and, when appropriate, restrain the risks associated with an organization's consolidated or group-wide activities. Consolidated supervision is a fundamental component of bank supervision in the United States and, increasingly, abroad. This is so because it provides important protection to the insured banks within the overall organization as well as the federal safety net that supports those banks. In addition, consolidated supervision aids in the detection and prevention of financial crises and, thus, mitigates the potential for systemic risk in the financial system.

History demonstrates that financial trouble in one part of a business organization can spread rapidly to other parts of the organization. This is particularly true if the parent holding company has weak financial or capital resources because the parent may well seek, or be required, to divert financial resources from a healthy subsidiary to aid either the parent or an ailing subsidiary. In the financial sector, examples of the propensity for financial difficulties to cascade among affiliates are many and include BCCI and Drexel Burnham Lambert, as well as numerous individual cases within the Texas banking crises of the 1980s.

Advances in information and communication technology, moreover, now allow holding companies to operate and manage their organizations on an integrated basis with little regard for the corporate boundaries that typically define the jurisdictions of supervisors. Thus, large, complex organizations typically maximize synergies and efficiencies within the overall organization by managing their operations based on lines of business that may cut across several different legal entities. In addition, these organizations increasingly rely on centralized processes to manage and control the risks that flow from their overall activities on a consolidated basis.

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. In order to fully understand and assess these risks, a supervisor must be able to analyze a business line on a consolidated basis across the organization, and then determine how the risks are transferred to and managed by the organization and its individual legal components. This process is particularly crucial to understanding the risks to and of banks that are part of a much larger organization. For example, an industrial loan company or other bank owned by a large firm may be partially or entirely dependent upon affiliates for critical services, such as computer support, treasury operations, accounting, personnel, management and even premises. Moreover, banks that are part of a large organization sometimes have no business independent of the bank's affiliates. For example, the bank's loans and deposits may be derived or solicited largely through or from affiliates. In these situations, it is particularly important that an agency have authority to examine the entire organization, address its capital strength and enforce safe and sound policies and operations throughout the organization and across affiliates.

Consolidated supervision provides the Board with both the ability to understand the financial strength and risks of the overall banking organization and the authority to address significant management, operational, capital and other deficiencies within the overall organization *before* these deficiencies pose a danger to subsidiary insured banks and the federal safety net. As the Treasury Department noted in its 1991 report and recommendations on modernizing the financial system, umbrella oversight of a financial company that controls an insured bank "is necessary to protect the insured depository [institution] from affiliate risk. Umbrella oversight is designed to identify problems in the holding company or affiliates that are likely to cause difficulties for the insured bank, and to apply remedial action."[1]

Consolidated supervision not only helps prevent bank failures, it also provides important tools for managing and resolving bank failures if and when they do occur. The Board has found the knowledge, understanding and authority that come from consolidated supervision to be essential aids in ensuring that the effects of a bank failure are contained and do not spread to the financial system more broadly.

These benefits explain why Congress for many years has generally required that the corporate owners of U.S. insured banks be subject to consolidated supervision. Experience with BCCI, which lacked a single supervisor capable of monitoring its diverse activities, motivated Congress to extend this requirement in 1991 to foreign banks seeking to enter the banking business in the United States.

These benefits also explain why consolidated supervision of financial groups that include banks now is broadly recognized as an international best practice. The Basel Committee on Banking Supervision has formally endorsed the important role that consolidated supervision plays in the supervision of banks and their groups and the International Monetary Fund and World Bank now evaluate countries for their compliance with this key international standard. In fact, the principles of consolidated supervision for financial groups are now embodied in the legal and regulatory structures of many countries, including the member countries of the European Union, and numerous other countries are working to incorporate consolidated supervisory requirements into their laws and regulatory practices.

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[1] Modernizing the Financial System: Recommendations for Safer, More Competitive Banks at 61 (1991).

2. What are the differences between consolidated supervision of a holding company and supervision of a bank by the appropriate federal banking agency?

There are important and material differences between the statutory authority granted to the Federal Reserve to supervise bank holding companies and their affiliates and the authority granted to the other federal banking agencies regarding affiliates of insured banks. In addition, there are significant differences in the manner and scope of the consolidated supervision of bank holding companies and their affiliates conducted by the Federal Reserve in comparison to the more limited supervision of affiliates of insured banks conducted by the other federal banking agencies.

The Bank Holding Company Act (BHC Act) establishes a comprehensive framework for the supervision of bank holding companies and their nonbank subsidiaries. The hallmarks of this supervisory framework are broad grants of authority to the Board to examine and obtain reports from bank holding companies and each of their subsidiaries, establish consolidated capital requirements for bank holding companies and take supervisory actions with respect to bank holding companies and their nonbank subsidiaries for unsafe or unsound practices or violations of law. No other federal banking agency has similar authority to supervise bank holding companies or their nonbank subsidiaries in such a complete manner.

Examinations. The BHC Act grants the Board broad authority to examine any bank holding company and any subsidiary of a bank holding company at any time. In addition to reviewing transactions and relationships between a bank holding company or subsidiary and its depository institution affiliates, this authority allows the Board to examine the bank holding company and any nonbank subsidiary of the bank holding company in order to monitor *their* operations and financial condition. It also allows the Board to examine these companies to assess the operational risks within the organization that may pose a risk to the safety and soundness of any depository institution affiliate and the company's or subsidiary's systems for monitoring and controlling those risks. In addition, it allows the Board to examine a bank holding company and any of its subsidiaries for compliance with any statute that the Board has authority to enforce. Under the broad examination authority conferred by the BHC Act, the Board may at any time examine any nonbank subsidiary of a bank holding company, whether or not it engages in transactions or has relationships with a depository institution affiliate.[2]

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[2] 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 USC 1844(c)(2)(B).

Pursuant to this authority, the Federal Reserve conducts examinations of all large, complex bank holding companies on a routine basis. Because the Board is authorized to examine the bank holding company and all of its subsidiaries, the Board is able to review the organization's systems for identifying and managing risk across the organization and its various legal entities and the overall financial strength of the organization. If this review indicates that deficiencies exist, the Board, through the examination or enforcement process, may require the organization to enhance its risk management policies, procedures or systems in order to protect the safety and soundness of the overall organization or its depository institution subsidiaries.

The Federal Reserve's history of supervising holding companies has allowed it to develop significant expertise and specialized examination techniques that are particularly suited to evaluating the overall financial stability of a holding company and the extent to which financial weaknesses of the parent organization or its nonbank affiliates may have a material effect on the safety and soundness of depository institution affiliates. Accordingly, the supervisory process for well managed and well capitalized holding companies often is different from the more intrusive supervision applied to banks directly. In particular, the degree and nature of supervision are tailored to an assessment of the financial, operational, legal, compliance, reputational and other risks of the organization as a whole and the organization's ability to identify and manage these risks across the organization and its various legal entities. This combination of legal authority and expertise allows the Federal Reserve to focus its supervisory efforts on entities within the overall organization that, because of their size, activities, condition, or importance to the organization, may have a material effect on the safety and soundness of the organization and its depository institution affiliates, regardless of whether or not the subsidiary has direct relationships or transactions with its depository institution affiliates.

In contrast, the appropriate federal banking agencies for insured banks are authorized to examine affiliates of banks (other than subsidiaries of the bank) *only* to the extent necessary to disclose the relationship between the bank and the affiliate and the effect of the relationship on the bank. This examination authority, while important and valuable in supervising the insured bank, is more limited than the authority granted under the BHC Act.

Capital. Key among the authorities granted to the Board is the authority to establish consolidated capital requirements governing bank holding companies. Consolidated capital requirements are an important tool for helping to ensure that bank holding companies are a source of financial strength, not weakness, for their subsidiary insured depository institutions.

Indeed, among the contributing factors in the failure of an FDIC-insured industrial loan company (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 examine the parent holding company to determine its financial strength. The FDIC incurred losses estimated at nearly 50 percent of the assets of the ILC as a result of that failure.

In that case, the corporate parent--which was exempt from the BHC Act and, consequently, not subject to the Board's examination or capital requirements--borrowed a significant amount of funds without capital support and down-streamed those funds to the ILC. The parent company expected this debt to be repaid through income received from the operations of the ILC. In an effort to generate sufficient income to repay the debt incurred by the parent company, the ILC quickly expanded its activities and took on significant additional risk. This ultimately led to the failure of the ILC. In the FDIC Inspector General's report reviewing the causes of this failure, which was forwarded to the Board, the Inspector General noted that, because the corporate parent of the ILC was exempt from the BHC Act, no federal supervisor had examined the parent holding company and the regulatory capital requirements that would have limited the borrowings of the parent did not apply.

Enforcement authority. The Board also has broad authority under the BHC Act and the Federal Deposit Insurance Act to take supervisory actions, including issuing cease and desist orders and imposing civil money penalties, against any bank holding company and any nonbank subsidiary of a bank holding company that engages in an unsafe or unsound practice or violates any law. No other federal banking agency is authorized to take an enforcement action against a bank holding company.[3]

The appropriate federal banking agency for an insured bank that is owned by a company that is not a bank holding company has limited authority to take enforcement actions against the corporate owner if the owner engages in an unsafe or unsound practice *in conducting the business of the bank*. Thus, unsafe and unsound practices that weaken the corporate owner of a bank, for example by significantly reducing the capital of the parent company, and practices that represent violations of law by the corporate owner are generally beyond the scope of the enforcement authority of the appropriate federal banking agency for an insured bank.

While ILCs are subject to supervision by the primary federal banking agency in the same manner as other insured banks, the supervisory framework established in the BHC Act does not apply to the corporate owners of ILCs. Consequently, despite the fact that many ILCs are owned by large and complex organizations, organizations that own an insured ILC in reliance on the ILC exception are not subject to consolidated supervision at the holding company level by any federal banking agency.

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[3] The BHC Act also authorizes the Board to order a bank holding company to divest any nonbank subsidiary if the Board finds that continued ownership of the subsidiary presents a serious risk to the financial safety, soundness or stability of an affiliated bank and is inconsistent with sound banking principles or the purposes of the BHC Act.

3. In 1987, industrial loan companies ("ILCs") were granted an exemption from the definition of "bank" in the Bank Holding Company Act. This exemption allows the corporate owners of an ILC to operate outside the consolidated supervision requirements of U.S. law. The exemption also allows an ILC to be owned by any type of commercial company.

a. What were the initial justifications for this exception? Do you believe these justifications remain valid today?

One of the primary purposes of the Competitive Equality Banking Act of 1987 was to close the so-called "nonbank bank" loophole, which allowed commercial and other firms to acquire and operate FDIC-insured banking institutions without being subject to the supervisory regime established by Congress in the BHC Act. Accordingly, these amendments expanded the definition of "bank" in the BHC Act to include: (1) any FDIC-insured bank (regardless of the activities it conducts); and (2) any banking institution that both offers transaction accounts and makes commercial loans (regardless of whether it is FDIC-insured).[4] Consequently, as a general matter, any company owning a "bank" under this definition is a bank holding company and subject to consolidated supervision.

In 1987, Congress also adopted certain exceptions from this new and broad definition of "bank" for specific types of institutions. Importantly, banks operating within these exceptions were subject to several restrictions that were intended to ensure that the institution did not become a full-service bank.[5]

One of the exceptions adopted in 1987 permits a company to acquire an FDIC-insured industrial loan company ("ILC") chartered in certain states (primarily Utah, California and Colorado) without being subject to the supervisory and activity restrictions generally applicable to bank holding companies under the BHC Act. The statute generally provides that an ILC may operate under this exception if, among other things, the ILC either has assets of less than $100 million or does not accept demand deposits that the depositor may withdraw by check or similar means for payment to third parties.[6]

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[4] Transaction accounts include demand deposits and other deposits that the depositor may withdraw by check or similar means for payment to third parties or others, such as negotiable order of withdrawal (NOW) accounts.

[5] For example, exceptions were added for limited-purpose banks that restrict their operations to credit card or trust and fiduciary activities. Banks operating under the credit card or trust exceptions are prohibited from accepting demand deposits or offering NOW accounts to individuals or businesses. Credit card banks also are prohibited from making commercial loans or having more than one deposit-taking office.

[6] An ILC chartered in a grandfathered state also is exempt if the ILC was in existence on August 10, 1987, and has not experienced a change in control since that date.

At the time this exception was adopted in 1987, ILCs generally were small, locally-owned institutions that had only limited deposit-taking or lending powers under state law. In 1987, the majority of ILCs had less than $50 million in assets and the largest ILC had assets of less than $400 million. Moreover, at that time, the grandfathered states were not actively chartering new ILCs. For example, Utah had a moratorium on the chartering of new ILCs.

Many things have changed since 1987. Several grandfathered states have enhanced the ILC charter to allow ILCs to conduct nearly all of the powers of state-chartered commercial banks. In addition, several grandfathered states have begun actively to charter new ILCs and promote ILCs as a method of avoiding the requirements of the BHC Act.

As a result, there has been a recent rise in both the number and size of ILCs operating under the exception. For example, in 1997, Utah lifted its moratorium on the chartering of new ILCs, allowed ILCs to call themselves "banks," and permitted ILCs to exercise nearly all of the powers of state-chartered commercial banks. Since that time, the number of Utah-chartered ILCs has nearly tripled, and the aggregate amount of assets controlled by Utah-chartered ILCs now is more than *twice* the aggregate total assets of all the banks, savings associations and credit unions chartered in that state.[7] In fact, one ILC operating under the exception now has more than $60 *billion* in assets and more than $50 *billion* in federally insured deposits. An additional eight exempt ILCs each have more than $1 billion in assets and collectively control more than $13.5 billion in insured deposits. Several large commercial companies, including General Motors, General Electric, Pitney Bowes, BMW, Volkswagen and Volvo, now own ILCs under this exception and use these banks to support various aspects of their global commercial operations.

In light of these developments, the Board believes it would be inappropriate for Congress to further expand the powers of exempt ILCs by authorizing ILCs to offer NOW accounts to businesses or granting ILCs the ability to branch *de novo* across state lines. NOW accounts are functionally indistinguishable from demand deposits and a federal authorization for ILCs to offer business NOW accounts would essentially allow ILCs to operate as full-service commercial banks.[8]

In addition, granting ILCs the right to engage in *de novo* interstate branching would allow these institutions to operate a nationwide banking franchise. The ILCs currently

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[7] All asset and deposit data are as of June 30, 2002.

[8] Although, as noted above, Utah law allows an ILC chartered in that state to exercise all of the powers of a state-chartered commercial bank, the Utah Banking Commissioner has not authorized any ILC to offer business NOW accounts. The proposed federal authorization of business NOW accounts would allow Utah-chartered ILCs to offer business NOW accounts without the Commissioner's consent.

owned or acquired in the future by a commercial or retail firm could, for example, establish a branch office at every location of the parent company across the United States under this proposal.

These proposals would essentially allow companies, including commercial companies, to own a full-service, nationwide, FDIC-insured bank without being subject to the supervisory framework that Congress has mandated for the corporate owners of all other full-service insured banks. Thus, these proposals would have precisely the result that Congress sought to prevent when it closed the "nonbank bank" loophole in 1987, and would promote competitive *inequality*, rather than competitive equality, in the financial marketplace.

It is also worth emphasizing again that these large insured ILCs with unregulated parents could be placed at significant risk by the operations or difficulties of their parent. Any subsequent losses to the FDIC ultimately have the potential of taxpayer liability and increased deposit insurance premiums for insured bank subsidiaries of regulated bank holding companies.

b. What are the implications of this exemption and recent legislative initiatives to expand the powers of ILCs for this nation's policy of maintaining the separation of banking and commerce?

The United States has a tradition of maintaining the separation of banking and commerce. This policy was reaffirmed most recently in the Gramm-Leach-Bliley Act, where Congress closed the unitary thrift loophole that previously allowed commercial firms to control an FDIC-insured savings association.

Several concerns historically have motivated Congress's approach to the mixing of banking and commerce. These include the concern that the affiliation of banks and commercial firms might create conflicts of interests that interfere with the role of banks as independent financial intermediaries or allow the formation of economically dominant conglomerates. Another concern has been that a bank within a commercial organization might be called upon to support a commercial affiliate in financial distress, thus exposing the bank, the federal safety net and the taxpayer to the risks of the commercial affiliate.

While it is true that technological and marketplace innovations have blurred the line between banking and commerce, the decision of whether, when or how combinations of banking and commerce should be allowed remains an important decision and one that, in our view, should be made by the Congress only after a full and informed debate on the topic. The recent experience of Japan and other Asian countries highlights the supervisory and economic issues associated with broad mixings of banking and commerce.

The ILC exception in the BHC Act allows any type of commercial, retail or other firm to own and operate a federally insured bank. As discussed above, several large commercial firms, including General Motors, General Electric, Pitney Bowes, BMW, Volkswagen and Volvo, already have taken advantage of this exception to acquire an insured bank. Furthermore, although California recently amended its law to prohibit commercial firms from acquiring a California-chartered ILC after September 1, 2002, other states, such as Utah, continue to allow any type of firm to acquire ILCs chartered in their states. Accordingly, there is potentially no limit on the number or type of firms that may acquire an insured bank under this exception.

Certain proposals pending before Congress would authorize exempt ILCs to offer NOW accounts to businesses and establish branches on a *de novo* basis nationwide. These proposals essentially would allow commercial firms to own and operate a full-service, insured bank on a nationwide basis. The branching proposal, for example, would allow commercial firms that currently own an ILC or any other commercial firm that acquires an ILC in the future to establish branches of the ILC at the company's offices, stores and retail outlets across the country. Similarly, the NOW account proposal would allow ILCs to offer business checking accounts and operate as the functional equivalent of a full-service insured bank. Accordingly, these proposals have the potential to enhance significantly the attractiveness of ILCs to commercial and retail firms and to undermine seriously the separation of banking and commerce.