

GAO

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

September 2005

# INDUSTRIAL LOAN CORPORATIONS

## Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority



G A O

Accountability \* Integrity \* Reliability



Highlights of [GAO-05-621](#), a report to the Honorable James A. Leach, House of Representatives

## Why GAO Did This Study

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

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

## What GAO Recommends

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

[www.gao.gov/cgi-bin/getrpt?GAO-05-621](http://www.gao.gov/cgi-bin/getrpt?GAO-05-621).

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

# INDUSTRIAL LOAN CORPORATIONS

## Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority

### What GAO Found

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

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

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

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**Abbreviations**

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

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

September 15, 2005

The Honorable James A. Leach  
House of Representatives

Dear Mr. Leach:

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

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

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

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

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

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

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

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

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

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

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

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

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## Results in Brief

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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## Background

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

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

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

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

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

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

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

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## Bank Holding Companies

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

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

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

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

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

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

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

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

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<sup>11</sup>12 C.F.R. § 225.4 (2004).

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## Historical Policies Governing Separation of Banking and Commerce

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

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<sup>12</sup>Bank Holding Company Act of 1956, Pub. L. No. 84-511 § 4.

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

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

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

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## ILCs Have Evolved Over Time

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

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

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<sup>14</sup>Depository Institutions Act of 1982, Pub. L. No. 97-320 § 703.

<sup>15</sup>*Id.*

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

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

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

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<sup>16</sup>Pub. L. No. 100-86.

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

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

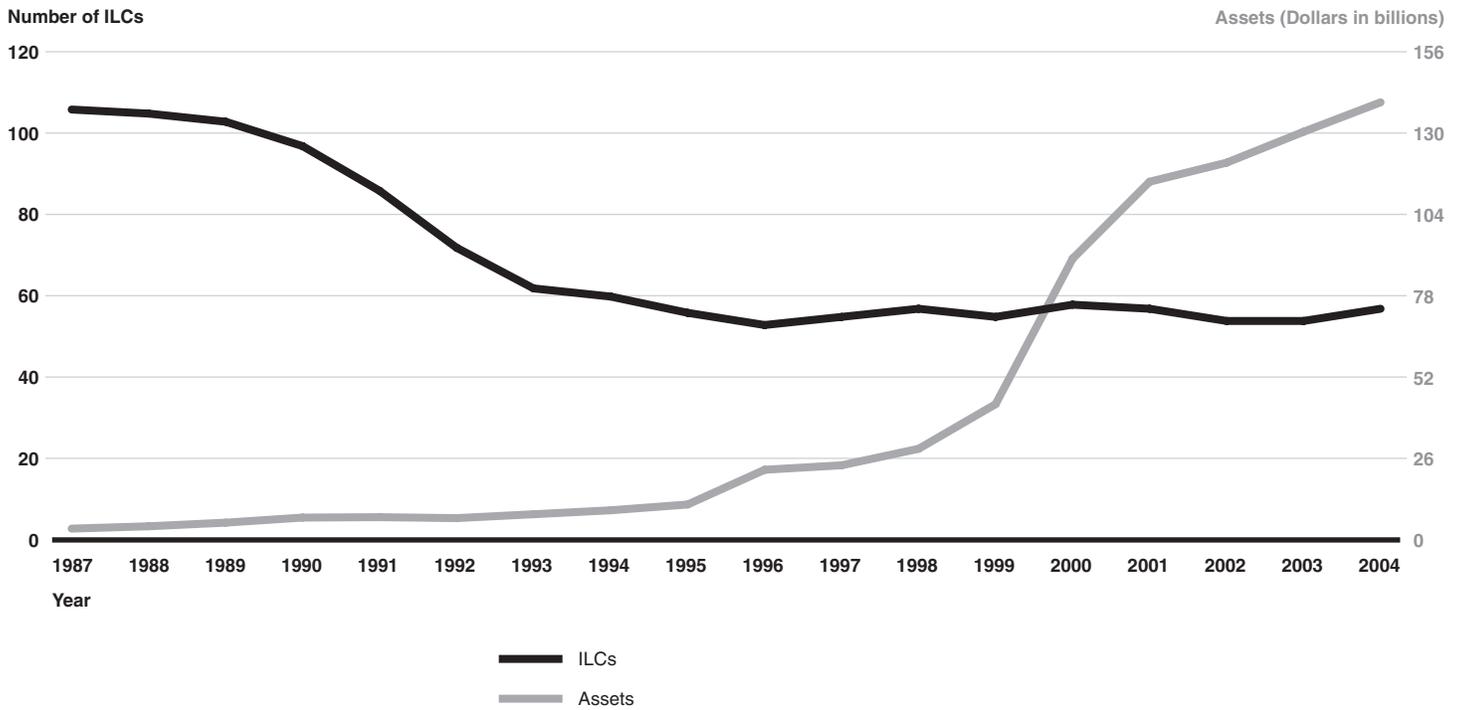
Since the passage of CEBA, the ILC industry has changed significantly and is currently a diverse group of insured financial institutions with a variety of business models. The majority of the 57 active ILCs, as of December 31, 2004, are owned and operated by financial services firms, such as the ILCs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

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## ILCs Have Experienced Significant Asset Growth

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

**Figure 1: Number and Total Assets of ILCs**



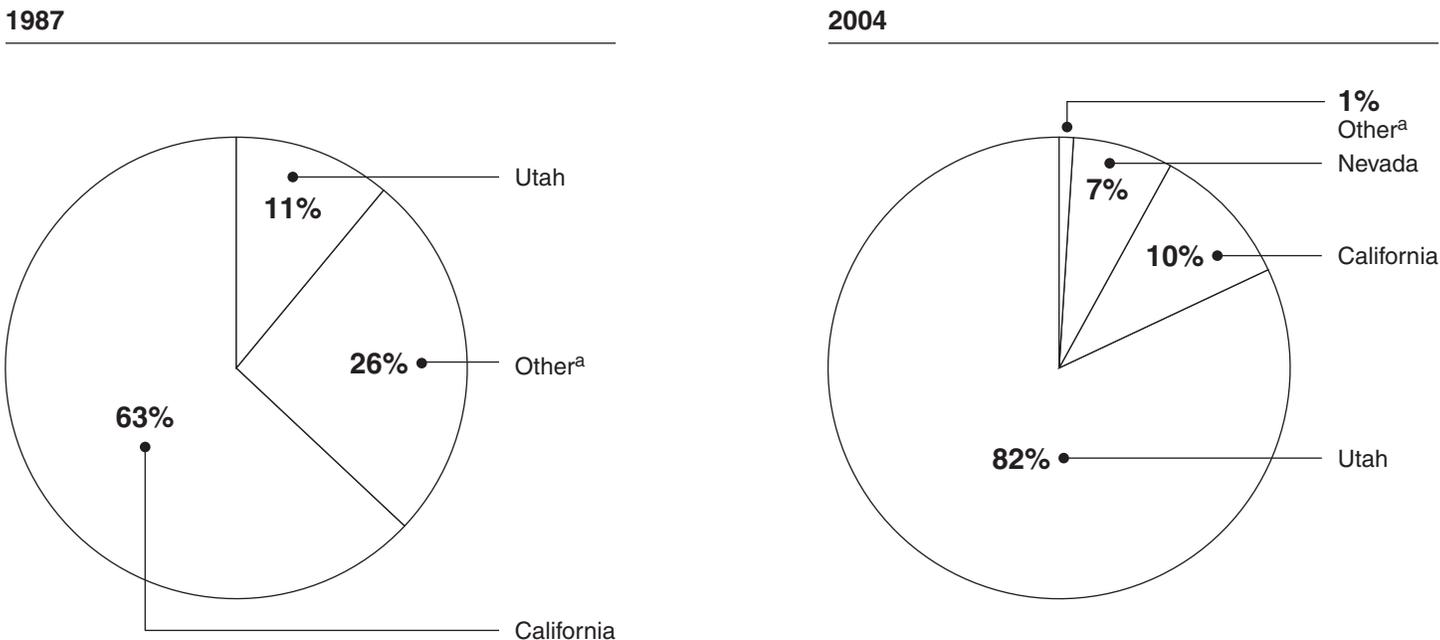
Source: GAO analysis of FDIC Call Report data.

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

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

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

**Figure 2: Percentage of ILC Assets Held by Individual States**



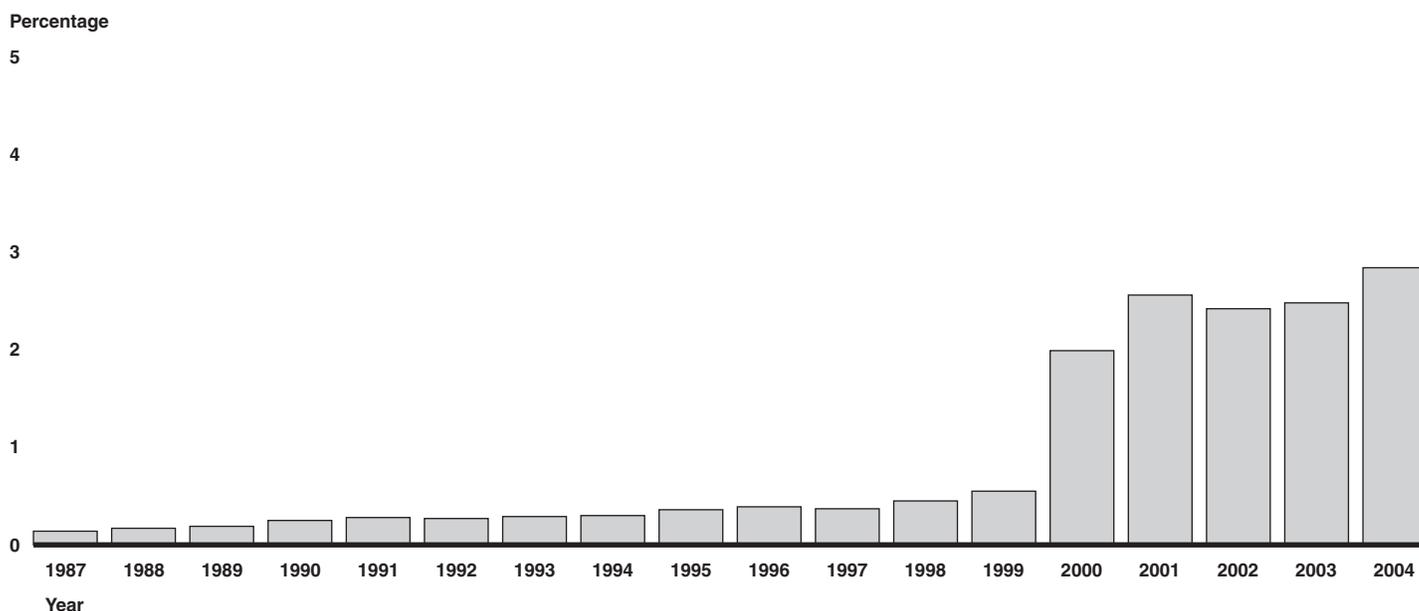
Source: GAO analysis of FDIC Call Report data.

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

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

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

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



Source: GAO analysis of FDIC Call Report data.

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

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

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

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### ILCs Are Permitted to Engage in Most Banking Activities

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

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

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

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

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

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

Source: FDIC.

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

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

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their operations through sources other than FDIC insured deposits and use commercial paper, brokered deposits.<sup>21</sup>

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

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

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

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

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

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

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### ILCs Must Comply with Federal Requirements Applicable to Other Insured Institutions

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

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

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

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

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

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

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

<sup>25</sup>See 12 C.F.R. § 337.3 (2005).

<sup>26</sup>See 12 C.F.R. Part 204.

<sup>27</sup>See 12 C.F.R. Part 329.

<sup>28</sup>See 12 C.F.R. Part 206.

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

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

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

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

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<sup>29</sup>See 12 C.F.R. Part 202.

<sup>30</sup>See 12 C.F.R. Part 226.

<sup>31</sup>See 12 C.F.R. Part 229.

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

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## FDIC and Consolidated Supervisors Use Different Supervisory Approaches

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

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

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

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

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

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

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<sup>33</sup>See 12 U.S.C. § 1831v(b).

<sup>34</sup>See 12 U.S.C. §§ 1844(c)(2)(A), 1467a.

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

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

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<sup>35</sup>See 12 U.S.C. § 1844(c)(2)(B).

<sup>36</sup>See 12 U.S.C. §§ 1467a(b)(4), 1831(a).

<sup>37</sup>See 12 U.S.C. §§ 1844(c)(2)(C), 1831v(a).

<sup>38</sup>See 12 U.S.C. § 1831v(b).

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

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

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

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

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<sup>40</sup>See 12 U.S.C. §§ 1844(c)(1), 1467a(b)(2), 1844(c)(1)(B), 1831v(a)(1).

<sup>41</sup>12 C.F.R. § 225.5(b) (Board); 12 C.F.R. § 562.4(a) (OTS).

<sup>42</sup>12 C.F.R. Part 225, Appendices B & C.

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

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<sup>43</sup>See 12 C.F.R. § 225.4(a).

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

<sup>45</sup>See, e.g., 12 U.S.C. §§ 1844(g), 1831v(a)(2), and 1843(l), respectively.

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

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

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

<sup>47</sup>See 12 U.S.C. 1820(b)(4)(A).

<sup>48</sup>See 12 U.S.C. 1831v(b).

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

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

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

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<sup>49</sup>See 12 U.S.C. § 1820(c).

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

<sup>51</sup>See 12 U.S.C. § 1813(u).

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

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

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

- Explicit authority
- ◐ Less extensive authority
- No authority

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

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

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

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

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

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

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

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

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

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

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

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

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

**Table 2: The Extent of Selected FDIC Authorities**

FDIC authority	Extent of authorities
Examine certain ILC affiliates. <sup>a</sup>	Only to determine whether the affiliate has a relationship with the ILC and, if so, to disclose the effect of the relationship on the ILC. The authority does not extend to determining how the affiliate's involvement in the holding company alone might threaten the safety and soundness of the ILC.
Impose conditions on or enter into agreement with an ILC holding company in connection with an application for deposit insurance.	Only in connection with an application for deposit insurance and cannot be used to unilaterally impose conditions on an ILC holding company after the application has been approved.
Terminate deposit insurance.	Only if certain notice and procedural requirements (including a hearing on the record before the FDIC Board of Directors) are followed after FDIC determines that <ul style="list-style-type: none"> <li>• the institution, its directors or trustees have engaged in unsafe or unsound practices;</li> <li>• the institution is in an unsafe or unsound condition; or</li> <li>• the institution, its directors or trustees have violated an applicable legal requirement, condition of insurance, or written agreement between the institution and FDIC.</li> </ul>
Obtain written agreements from the acquiring entity in connection with a proceeding to acquire an ILC. <sup>b</sup>	Could be used if grounds for disapproval exist with respect to the acquirer.
Take enforcement actions against ILC affiliates. <sup>c</sup>	Only if an affiliate is an IAP; and  Only if the IAP engages in an unsafe or unsound practice in conducting the business of the ILC or has violated a legal requirement. If the IAP is functionally regulated, FDIC's enforcement grounds are further limited.

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

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

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

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

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

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

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

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

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

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

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

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

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<sup>54</sup>See 12 U.S.C. § 1820(c).

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

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

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

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

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

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

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<sup>57</sup>See 12 U.S.C. §§ 1815(a)(4), 1816.

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

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<sup>58</sup>FDIC's incidental powers are set forth at 12 U.S.C. 1819(a)(Seventh).

<sup>59</sup>See 12 U.S.C. § 1818(b)(1).

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

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

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

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<sup>61</sup>See 12 U.S.C. § 1831o(e)(2)(C), (f)(I)(ii).

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

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

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

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

<sup>63</sup>See 12 U.S.C. § 1818(a)(3),(5).

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

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

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

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

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

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

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

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

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

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

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

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<sup>66</sup>See 12 U.S.C. §§ 1831v, 1848a.

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

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

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

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

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

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

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

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

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**Table 3: Affiliate Related Examination Procedures**

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

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Source: FDIC.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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**State Supervisors  
Contribute to ILC  
Supervision, but Resources  
Vary**

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

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

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

<sup>72</sup>See Utah Code Ann. § 7-1-510.

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

(Dollars in billions)

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

Sources: GAO and FDIC data.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Name of ILC (year of failure) assets at closing	Cause of failure	Amount of loss to the fund	FDIC's response
Pacific Thrift & Loan; Woodland Hills, Calif. (1999)	<p>Poor corporate governance.</p> <p>Poor risk management.</p> <p>Lack of risk diversification.</p>	\$42 million (as of 01/01/02)	<p>Modified risk focused examination procedures.</p> <p>Issued internal guidance on:</p> <ul style="list-style-type: none"> <li>• subprime lending programs, and</li> <li>• real estate lending standards.</li> </ul> <p>Modified guidance for examining high-risk residual assets (e.g., Modifications to Capital Markets Examination handbook, specifically mortgage derivative securities, asset-backed securities, structured notes, and securitization).<sup>a</sup></p> <p>Issued a proposed rule to revise risk-based capital requirements (e.g., Financial Institution</p>
<b>Total assets: \$117.6 million at closing</b>	<p>Annual financial statement audit did not identify the actual financial condition of the bank.</p> <p>Inappropriate accounting for estimated future revenue from high risk assets.</p> <p>Auditors did not provide a written report of internal control weaknesses to the bank audit committee and examiners.</p> <p>Auditors did not provide examiners access to workpapers and supporting documentation.</p>		
Southern Pacific Bank; Torrance, Calif. (2003)	<p>Poor corporate governance.</p> <p>Poor risk management.</p> <p>Lack of risk diversification.</p>	\$63.4 million (as of 12/31/04)	<p>Letter, <i>Capital Treatment of Residual Interest in Asset Securitizations</i>, issued 9/2000).</p> <p>Hosted a symposium for FDIC regional management on "Lessons Learned" from bank failures.</p> <p>Required that contracts with third parties providing audit services include a provision to provide examiners access to audit workpapers and supporting materials.</p>
<b>Total assets: \$1.1 billion at closing</b>	<p>Annual financial statement audit did not identify the actual financial condition of the bank.</p> <p>Auditors did not provide a written report of internal control weaknesses to the bank audit committee and examiners.</p>		

Sources: GAO, FDIC, and FDIC-IG.

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

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

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

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

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

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

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

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

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

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

<sup>78</sup>*In Re: Toyota Financial Savings Bank Henderson, Nevada, Application for Federal Deposit Insurance*, Federal Deposit Insurance Corporation, January 2004.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

<sup>84</sup>Pub. L. No. 106-102 § 401 (1999).

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

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

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

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

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

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<sup>85</sup>See 12 U.S.C. § 1468(a).

<sup>86</sup>See 12 U.S.C. § 1464(c)(2)(A).

<sup>87</sup>See 12 U.S.C. § 1467a(m).

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

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

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

<sup>89</sup>See 12 U.S.C. § 1843(k)(4)(H).

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

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

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

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<sup>90</sup>See 12 U.S.C. § 1841(c)(2)(F).

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

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### Mixing Banking and Commerce Presents Both Risks and Potential Benefits

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

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

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

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

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

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

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

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

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

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

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One primary factor in the lack of empirical evidence may be that, because of the policy generally separating banking and commerce, few institutions are available for study.

However, product synergies between banking and commercial firms may exist in certain industries. For example, several automobile manufacturers own or operate captive financing affiliates that generally provide credit to borrowers at competitive rates to facilitate the commercial holding company's efforts to sell automobiles. Some of these affiliates are insured depository institutions while others rely on the capital markets, their commercial holding companies, or banks for funding. Additionally, other regulators and practitioners noted that commercially affiliated insured depository institutions might benefit from access to existing commercial holding company or affiliate customers. For example, insured banks owned or affiliated with commercial firms may be able to attract deposits or potential credit card customers through targeted marketing to the commercial holding company or affiliate customers. Industry observers we spoke with also told us that commercially affiliated banks might benefit from stronger brand recognition and, in instances where banks are owned by retailers, the banks may benefit from being located in stores that keep longer hours of operation. Furthermore, as discussed previously, combined firms may generate efficiencies from the sharing of fixed costs, such as computer systems or accounting functions.

One OTS official and industry practitioners we talked with were less convinced of potential economic efficiencies from mixing banking and commerce and suggested that these firms might not have a competitive advantage over other businesses. For example, an OTS official we talked with provided us with instances where the commercial owners of insured banks operating under the "nonbank bank" exemption had subsequently sold their insured banking subsidiaries because these firms may not have been able to realize expected operational efficiencies from mixed banking and commerce. For instance, a published study we reviewed noted that, in the late 1980s, a large retailer's efforts to cross market its traditional product line and financial services failed to generate expected synergies. The study highlighted the management challenges associated with linking the conglomerate's insurance, securities, real estate, retail, and catalog businesses. The study also mentioned difficulties managing accurate customer information and division management concerns about other divisions pursuing their customers as reasons for the conglomerate's inability to capture expected synergies. Further, the study noted the financial services centers operating inside the traditional retailer's stores

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generally proved unprofitable. Eventually, the retailer cited in the study abandoned its diversification strategy and sold its financial services business. Similarly, a practitioner we spoke with stated that success in the banking industry may require skill sets that are different from the expertise and business practices in commercial sectors of the economy.

While there is little direct research assessing the competitive effects of mixing banking and commerce, the incentives to mix banking and commerce may in some way be linked to research indicating that operational efficiencies may result from merging two banks. According to this research, there is a general expectation that operational efficiencies may be realized from scale and scope economies within the banking industry. For example, merging two banks can result in gains from the closing of redundant branches, consolidating systems and back offices, and marketing products, such as credit cards, to broader customer bases. Some of these same operational efficiencies—such as the marketing of credit cards to a broader customer base—would presumably be available to mixed banking and commercial firms as well. However, empirical studies have not found clear evidence that bigger is necessarily better in banking. For example one study noted that while large banking operations were regarded as advantageous, the conclusions in academic literature on economies of scale and scope within merged banks are mixed. Our own independent review of academic literature reached similar conclusions. Some studies documented economies of scale and scope in banking, but others were less conclusive. Additionally, while some recent studies we reviewed suggested that recent advances in information technology may be contributing to greater opportunities for economies of scale and scope within the banking industry, these studies do not provide conclusive evidence on the competitive implications of mixing banking and commerce.

The mixed findings on scale and scope economies within academic literature we reviewed are in many ways consistent with market activity post GLBA. Because GLBA removed several restrictions on the extent to which conglomerates could engage in banking and nonbanking financial activities, such as insurance and securities brokerage, some analysts had expected that conglomeration would intensify in the financial services industry after GLBA. However, as yet, this does not seem to have happened. The reasons vary. Many banks may not see any synergies with insurance underwriting. Additionally, it may be that many mergers are not economically efficient, the regulatory structure set up under GLBA may not be advantageous to these mergers, or, it is simply too soon to tell what the

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impact will be. Further, a general slowdown occurred in merger and acquisition activity across the economy in the early 2000s, which may also be a contributing factor to the pace of industry conglomeration post GLBA.

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## Recent Legislative Proposals May Increase the Attractiveness of Operating an ILC

FDIC-insured banks, including ILCs, are currently not permitted to offer interest-bearing business checking accounts. Recent legislative proposals would remove the current prohibition on paying interest on demand deposits and, separately, authorize insured depository institutions, including most ILCs, to offer interest-bearing business NOW accounts.<sup>92</sup> This would, in effect, expand the availability of products and services that insured depository institutions, including those ILCs, could offer. ILC advocates we spoke with highlighted that including ILCs in these legislative proposals maintains the current relative parity between ILC permissible activities and those of other insured bank charters. However, Board officials and some industry observers we spoke with told us that granting grandfathered ILCs the ability to offer business NOW accounts represents an expansion of powers for ILCs, which could further blur the distinction between ILCs and traditional banks. Another legislative proposal, introduced but not passed in the last congressional session, would allow banks and most ILCs (those included in a grandfathered provision) to branch into other states through establishing new branches—known as de novo branching—by removing states' authority to prevent them from doing so.<sup>93</sup> Board officials we spoke with told us that, if enacted, these proposals could increase the attractiveness of owning an ILC, especially by private sector financial or commercial holding companies that already operate existing retail distribution networks.

As previously discussed, in order to remain exempt from the definition of a bank under the BHC Act, most ILCs may not accept demand deposits, if their total assets are \$100 million or more. However, ILCs are not restricted from offering NOW accounts, which are insured deposits that, in practice, are similar to demand deposits. Current federal banking law prohibits insured depository institutions from paying interest on demand deposits and does not authorize insured depository institutions to offer NOW

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<sup>92</sup>See H.R. 1224, 109<sup>th</sup> Cong. § 3 (2005).

<sup>93</sup>H.R. 1375 108<sup>th</sup> Cong. § 401(b) (2004). This bill would permit de novo interstate branching by ILCs subject to the grandfathering provisions described later in our discussion of legislative proposals to permit interest-bearing business checking accounts.

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business checking accounts. According to a Treasury official, the prohibition on paying interest on demand deposits, including those maintained by businesses, was enacted in the 1930s because of concerns about the solvency of the nation's banks and the belief that limiting competition among banks would reduce bank failures. This ban was designed to protect small rural banks from having to compete for deposits with larger institutions that could offer higher interest rates and use the deposits to make loans to stock market speculators and deprive rural areas of financing.

There have been repeated legislative proposals to repeal this prohibition. Supporters of these efforts have stated that the prohibition on paying interest on demand deposits, including those maintained by businesses, is an unnecessary and outdated law that unfairly affects small businesses. According to these supporters, small businesses tend to bank at smaller institutions that do not offer sweep accounts which, in effect, circumvent the ban on interest bearing demand accounts, because their deposit balances may not qualify for these accounts at larger institutions.<sup>94</sup> The most recent legislative proposals would repeal section 19(i) of the Federal Reserve Act and section 18(g) of the FDI Act, which, together with other federal laws, effectively prohibit the payment of interest on demand deposits, including business checking accounts.<sup>95</sup> This would allow insured depository institutions to pay interest on their demand deposits, including those maintained by businesses, although it would not remove the BHC Act provision exempting larger ILCs from the definition of a bank on the condition, among others, that they do not accept demand deposits. Separate provisions of this legislative proposal would allow qualified ILCs (which would include ILCs owned or controlled by a commercial firm where the ILC obtained deposit insurance prior to October 1, 2003, and did not undergo a change in control after September 30, 2003) to offer business NOW accounts. Going forward, other ILCs could offer business NOW accounts, provided that their state supervisors determine that at least 85% of their holding company and affiliated entities' gross revenues were from activities that were financial in nature or incidental to a financial activity in at least three of the prior four calendar quarters. In effect, this amendment would make it difficult for nongrandfathered ILCs owned by commercial

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<sup>94</sup>Generally, sweep accounts use computers to analyze customer accounts and automatically transfer funds at the end of each day to higher-interest earning money market accounts.

<sup>95</sup>H.R. 1224 § 3. See 12 U.S.C. §§ 371a, 1828(g), 1832.

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enterprises to offer interest bearing business NOW accounts. ILC advocates we spoke with highlighted that if other insured banks are permitted to offer interest bearing demand deposit accounts to businesses, granting ILCs the ability to offer interest bearing business NOW accounts maintains the current relative parity between ILC permissible activities and those of other insured bank charters. Officials at the Board have opposed ILCs being able to offer interest bearing business NOW accounts, unless ILC holding companies were subjected to consolidated supervision and the same activity restrictions applied to the holding companies of most other insured depository institutions, because doing so would further enable ILCs to become the functional equivalent of full-service banks and expand their operations beyond the historical function of ILCs and the terms of their exemption in current banking law.

Federal banking law permits insured state banks and ILCs to expand on an interstate basis by acquiring another institution, provided that state law does not expressly prohibit an interstate merger.<sup>96</sup> However, banks and ILCs are not permitted to branch in another state without having an established charter in that state and without acquiring another bank—known as *de novo* branching—unless the host state enacted legislation that expressly permitted this practice.<sup>97</sup> Currently, only 17 states have enacted this legislation. According to proponents of *de novo* branching, current restrictions make it difficult for small banks seeking to operate across state lines and puts banks at a disadvantage compared with savings associations, which are permitted to establish interstate *de novo* branches. A proponent also stated that *de novo* branching would benefit small banks near state borders to better serve customers by establishing new branches across state lines and would increase competition by providing banks with a less costly method for offering their services in new locations.

According to a Utah state bank supervisory official we spoke with, ILCs in some states have the ability to establish branches in certain other states through reciprocal branching agreements. For example, this official stated that ILCs in Utah have reciprocity agreements with 17 other states and are able to branch, without federal *de novo* branching authority, into these 17 states. However, this Utah state supervisory official and industry practitioners told us that many ILC business models do not rely on retail

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<sup>96</sup>See 12 U.S.C. §§ 1831u.

<sup>97</sup>See 12 U.S.C. § 1828(d).

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branching to conduct their business operations. For example, currently only two Utah ILCs have branches, and they have only two branches each. According to Board officials, granting ILCs unrestricted de novo branching authority in other states may increase the relative attractiveness of ILCs as compared with other financial institution charters. These officials highlighted that reduced restrictions on nationwide branching may increase private sector interest in ILC ownership by financial or commercial holding companies that operate retail distribution networks. However, according to at least one industry expert we spoke with, the effects of the consequences of de novo branching may be overstated and not likely to result in major changes in the ILC industry.

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## Conclusions

ILCs have significantly evolved from the small, limited purpose institutions that existed in the early 1900s. In particular, the ILC industry has grown rapidly since 1999 and, in 2004, six ILCs were among the 180 largest financial institutions with \$3 billion or more in total assets, and one institution had over \$66 billion in assets. Because of the significant recent growth and complexity of some ILCs, the industry has changed since being granted an exemption from consolidated supervision in 1987, and some have expressed concerns that ILCs may have expanded beyond the original scope and purpose intended by Congress.

The vast majority of ILCs have corporate holding companies and affiliates and, as a result, are subject to similar risks from holding company and affiliate operations as banks and thrifts and their holding companies. However, unlike bank and thrift holding companies, most ILC holding companies are not subject to federal supervision on a consolidated basis. Although FDIC has supervisory authority over an insured ILC, it does not have the same authority to supervise ILC holding companies and affiliates as a consolidated supervisor. While the FDIC's authority to assess the nature and effect of relationships between an ILC and its holding company and affiliates does not directly provide for the same range of examination authority, its cooperative working relationships with state supervisors and ILC holding company organizations, combined with its other bank regulatory powers, has allowed the FDIC, under limited circumstances, to assess and address the risks to the insured institution and to achieve other results to protect the Fund against ILC-related risks. However, we are concerned that insured institutions providing similar risks to the Fund are not being overseen by bank supervisors that possess similar powers.

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FDIC has responded appropriately to the challenges it faces supervising the ILC industry by implementing significant enhancements to its examiner guidance designed to mitigate the risks that could be posed to insured depository institutions, including ILCs, from various sources, such as holding companies and affiliates. Within the scope of its authority, FDIC has demonstrated that its supervisory approach has, in some instances, effectively mitigated losses to the Fund. Some have even stated that, from a safety and soundness perspective, FDIC's approach is an effective alternative to the Board's bank holding company supervision, given that FDIC has successfully mitigated losses to the Fund posed by some troubled institutions. However, the Board disagrees and stated that FDIC's approach, without the aid of consolidated supervision, cannot effectively assess all the risks to a depository institution posed by the holding company and affiliates of an ILC. Moreover, the extent of some of FDIC's authorities over ILC holding companies and affiliates is not clear. For example, it is unclear under what circumstances FDIC could compel ILC affiliates to provide information about their operations when these affiliates do not have a relationship with an ILC. As a result, absent a cooperative working relationship, FDIC's supervisory approach may not be able to identify or address all potential risks to the insured institution. It is also unclear how effective the FDIC's approach would be if the ILC industry incurred widespread and significant losses or if a large complex ILC were to become troubled. As a result of differences in supervision, we and the FDIC-IG have found that, from a regulatory standpoint, ILCs in a holding company structure may pose more risk of loss to the Fund than other types of insured depository institutions in a holding company structure.

Although federal banking law may allow ILC holding companies to mix banking and commerce to a greater extent than holding companies of other types of depository institutions, we were unable to identify any conclusive empirical evidence that documented operational efficiencies from mixing banking and commerce, and the views of bank regulators and practitioners were mixed. Including ILCs in recent legislative proposals to offer business checking accounts and operate de novo branches nationwide maintains the current relative parity between ILC permissible activities and those of other insured bank charters. These legislative proposals may make the ILC charter more attractive and encourage future growth. However, the potential risks from combining banking and commercial operations remain, including the potential expansion of the federal safety net provided for banks to their commercial entities, increased conflicts of interest within a mixed banking and commercial conglomerate, and increased economic

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power exercised by large conglomerate enterprises. In addition, we find it unusual that this limited exemption for ILCs would be the primary means for mixing banking and commerce on a broader scale than afforded to the holding companies of other financial institutions. Because it has been a long time since Congress has broadly considered the potential advantages and disadvantages of mixing banking and commerce and given the rapid growth of ILC assets and the potential for increased attractiveness of the ILC charter, it would be useful for Congress to review the ILC holding company's ability to mix banking and commerce more than other types of financial institutions and whether the holding companies of other financial institutions should be permitted to engage in this level of activity.

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## Matters for Congressional Consideration

Consolidated supervision is a recognized method of supervising an insured institution, its holding company, and affiliates. While FDIC has developed an alternative approach that it claims has mitigated losses to the bank insurance fund, it does not have some of the explicit authorities that other consolidated supervisors possess, and its oversight over nonbank holding companies may be disadvantaged by its lack of explicit authority to supervise these entities, including companies that own large and complex ILCs. To better ensure that supervisors of institutions with similar risks have similar authorities, Congress should consider various options such as eliminating the current exclusion for ILCs and their holding companies from consolidated supervision, granting FDIC similar examination and enforcement authority as a consolidated supervisor, or leaving the oversight responsibility of small, less complex ILCs with the FDIC, and transferring oversight of large, more complex ILCs to a consolidated supervisor.

The long-standing policy of separating banking and commerce has been based primarily on mitigating the potential risk that combining these operations may pose to the Fund and the taxpayers. GLBA reaffirmed the general separation of banking from commerce and providing financial services from nonfinancial commercial firms. However, under federal banking law, the ILC charter offers commercial holding companies more opportunity to mix banking and commerce than other insured depository institution charters. Congress should also be aware of the potential for continued expansion of large commercial firms into the ILC industry—especially if ILCs are granted the ability to de novo branch and offer interest bearing business checking accounts. In recent years, this policy issue has been addressed primarily through exemptions and provisions to existing laws rather than assessed on a comprehensive basis. Thus,

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Congress should more broadly consider the advantages and disadvantages of mixing banking and commerce to determine whether continuing to allow ILC holding companies to engage in this activity more than the holding companies of other types of financial institutions is warranted or whether other financial or bank holding companies should be permitted to engage in this level of activity.

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## Agency Comments and Our Evaluation

We provided a draft of this report to the Board, FDIC, OTS, and SEC for review and comment. Each of these agencies provided technical comments that were incorporated as appropriate. In written comments, the Chairman of the Board of Governors of the Federal Reserve System (see app. II) concurred with the report's findings and conclusions. Specifically, the Chairman stated that "consolidated supervision provides important protections to the insured banks that are part of a larger organization, as well as the federal safety net that supports those banks." The Chairman also wrote that our report "properly highlights the broad policy implications that ILCs raise with respect to maintaining the separation of banking and commerce."

In written comments from the Chairman of the Federal Deposit Insurance Corporation (see app. III), FDIC concurred with one of the report's findings but generally believed that no changes were needed in its supervisory approach over ILCs and their holding companies and disagreed with the matters for congressional consideration. Specifically, the FDIC concurred that from an operations standpoint, ILCs do not appear to have a greater risk of failure than other types of insured depository institutions. However, FDIC's disagreements generally focused on three primary areas—whether consolidated supervision of ILC holding companies is necessary to ensure the safety and soundness of the ILC; that FDIC's supervisory authority may not be sufficient to effectively supervise ILCs and insulate insured institutions against undue risks presented by external parties; and the impact that consolidated supervision of ILCs and their holding companies would have on the marketplace and the federal safety net.

First, in its comments about consolidated supervision for ILCs and their holding companies, FDIC stated that its bank-centric supervision, enhanced by sections 23A and 23B of the Federal Reserve Act and the Prompt Corrective Action provisions of the FDIC Improvement Act, is a proven model for protecting the deposit insurance funds, and no additional layer of consolidated federal supervision of ILC holding companies is necessary. As stated in our report, we agree that FDIC's approach has

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effectively mitigated the risk of loss to the Fund in some instances. However, FDIC's approach has only been tested on a limited basis in relatively good economic times. FDIC also expressed concern that our report did not include a comparison of the effectiveness and cost of FDIC's bank-centric approach with the effectiveness and cost of consolidated supervision. As stated in our report, the scope of this review did not include an assessment of the extent to which regulators effectively implemented consolidated supervision or any other type of supervision. Rather, we focused on the respective regulators' authorities to determine whether there were any inherent limitations in these authorities. Consolidated supervision is widely recognized nationally and throughout the world as an accepted approach to supervising organizations that own or control financial institutions and their affiliates, and we are not aware of any empirical evidence, or a reliable method of gathering such evidence, that could be used to draw meaningful conclusions about the costs and benefits of either supervisory approach. Further, during our review we did not become aware of any significant concerns over the cost of consolidated supervision. While we recognize that consolidated supervision would likely pose some additional cost to ILC holding companies, determining the extent of this cost would be speculative, depending on the scope of coverage of consolidated supervision (including whether current ILC parents would be grandfathered or whether ILCs below some size threshold would be exempt). Further, we believe that as one considers any additional costs, consideration should also be given to the benefits obtained from the enhanced supervisory tools and authorities that ILC regulators could use to better protect the Fund.

Further, FDIC believes that no additional layer of consolidated federal supervision of ILC holding companies is necessary and asserts that the report inappropriately repeated assertions by the Board which speculated that excessive debt at the parent of Pacific Thrift and Loan (PTL), an ILC, caused PTL to engage in higher-risk strategies that resulted in the ILC's failure. FDIC further stated that these assertions were not supported by the FDIC-IG's material loss review. We disagree that the information presented in the report is not supported by the FDIC-IG's review of PTL. As we report, the IG did not specifically identify PTL's excessive debt as a cause of failure. The IG found that inappropriate valuation of PTL's residual assets (i.e., the assets that PTL retained after it packaged and sold loans) ultimately caused the collapse of the bank. As FDIC notes, it and the other bank regulators have subsequently tightened rules for this valuation. However, the collapse of PTL was not purely an issue of inappropriate accounting. The IG found that while PTL's parent "was incurring

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monumental amounts of debt, no federal agency was present to regulate these activities. The major problem with the borrowing arrangement was whether or not [the parent] had the financial wherewithal to repay the debt on a stand-alone basis without relying on PTL for financial support.” The IG’s report also stated that PTL’s new “management team immediately implemented an expansionary program of originating and selling subprime mortgage loans...without regard to adequate policies, programs, and controls [which] resulted in serious shortcomings.” We believe that one of the significant benefits of consolidated supervision is that it may better position a regulator to obtain an earlier awareness of possible problems within a holding company structure that could have an impact on the insured bank than does the FDIC’s bank-centric approach. Had there been a greater regulatory presence at the holding company, potentially, problems at PTL may have been identified earlier or averted. Further, the Board’s view of all of the contributing factors to PTL’s failure is necessary to have a balanced discussion of this event.

Second, FDIC commented that it does not need any additional supervisory authority and has an excellent track record of identifying potential problems at nonbank subsidiaries and taking appropriate corrective action. FDIC further stated that the report too narrowly interpreted its examination authority. We agree that within the scope of its authority, FDIC has demonstrated that its supervisory approach has, in some instances, effectively mitigated losses to the Fund. However, we disagree that the report narrowly interprets FDIC’s various authorities and continue to believe that consolidated supervision offers broader examination and enforcement authorities that may be used to understand, monitor, and, when appropriate, restrain the risks associated with insured depository institutions in a holding company structure. Further, as stated in the report, consolidated supervisors can compel holding companies and nonbank subsidiaries to provide key financial and operational reports and can impose consolidated or parent-only capital requirements that are important tools used to help ensure the safety and soundness of an insured depository institution. We continue to be concerned that FDIC’s bank-centric approach relies on voluntary participation by regulated and unregulated entities to provide this key information, and that this approach has only been tested during a favorable economic environment. The ILC industry is growing rapidly and some ILCs are becoming increasingly complex. Thus, we believe it is important for the Congress to consider whether insured institutions providing similar risks to the Fund should also be overseen by bank supervisors that uniformly possess similar powers.

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Third, in its comments, FDIC also stated that consolidated supervision of ILCs and their holding companies would result in greater federal involvement with commercial parents and nonbank subsidiaries. While we agree that more commercial entities would be subject to federal oversight, we disagree with FDIC's comment that such oversight "would represent a new level of government intrusion in the marketplace" and would "radically restructure" the federal government's role relative to commercial firms. Subjecting commercial ILC holding companies to consolidated supervision currently would affect a relatively small number of firms that chose to own and operate ILCs and provide them with a similar level of oversight afforded to other firms owning insured depository institutions. In so doing, consolidated supervision could better ensure that there is sufficient regulatory authority to effectively supervise these entities. Our report, however, raises oversight concerns with not only commercial holding company ownership of ILCs, but also discusses the development of a small number of more complex ILCs owned by financial-oriented holding companies that are currently exempt from consolidated supervision. At this time, it is more so because of the advent of these larger institutions—which increases the potential risk to the Fund—rather than commercial ownership of ILCs, that we believe this lack of consolidated supervision merits additional congressional scrutiny.

FDIC further stated that such supervision may call into question the individual accountability of insured institutions owned by large organizations to manage their own capital and could lead to an unintended expansion of the federal safety net to these entities. We disagree that consolidated supervision would have this effect since many institutions currently manage their capital, and regulators assess its adequacy on a consolidated basis. Further, the report does not advocate an expansion of the federal safety net. Rather, this report advocates that ILCs and their holding companies be regulated in a similar manner as other insured depository institutions and their holding companies.

Historically, limited charter entities such as ILCs and nonbank banks were exempt from consolidated supervision. However, ILCs have evolved from small, limited purpose institutions and are exempt from business activity limitations that generally apply to the holding companies and affiliates of other FDIC-insured depository institutions offering similar services. Further, ILCs may provide a greater means for mixing banking and commerce than ownership of or affiliation with other insured depository institutions. Given the changes and growth in the ILC industry, we see less distinction now between ILC holding companies and other holding

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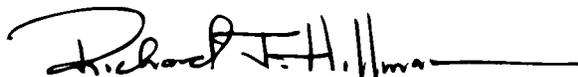
companies owning insured depository institutions, and it is unclear why a different regulatory approach would be used to supervise ILCs. As a result, we continue to believe that Congress should consider various options such as eliminating the current exclusion for ILCs and their holding companies from consolidated supervision, granting FDIC similar examination and enforcement authority as a consolidated supervisor, or leaving the oversight responsibility of small, less complex ILCs with the FDIC, and transferring oversight of large, more complex ILCs to a consolidated supervisor.

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As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time we will send copies of this report to the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs; Chairman and Ranking Minority Member of the House Committee on Banking, Housing, and Urban Affairs; and other congressional committees. We also will send copies to the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Securities and Exchange Commission, and make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

This report was prepared under the direction of Dan Blair, Assistant Director. If you or your staff have any questions regarding this report, please contact me at (202) 512-8678 or [hillmanr@gao.gov](mailto:hillmanr@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors are acknowledged in appendix IV.

Sincerely yours,

A handwritten signature in black ink that reads "Richard J. Hillman" followed by a horizontal line.

Richard J. Hillman  
Managing Director, Financial Markets  
and Community Investment

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# Objectives, Scope, and Methodology

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To describe the history and growth of the industrial loan corporation (ILC) industry, we analyzed Federal Deposit Insurance Corporation (FDIC) Call Report and Statistics on Depository Institutions (SDI) data on ILCs including total assets and estimated insured deposits from 1987 through 2004 to determine the (1) number of ILCs by year and by state, (2) total ILC industry assets by year and by state, and (3) ILC industry estimated insured deposits as a percentage of total estimated insured deposits by year. Prior to using the Call Report and SDI data, we assessed its reliability by (1) reviewing existing information about both data systems (2) interviewing agency officials knowledgeable of both data systems to discuss the sources of the data variables and the controls in place to ensure the accuracy and integrity of the data, and (3) performing various electronic tests of the required data elements. Based on our work, we determined that the data from both the Call Report and SDI systems were sufficiently reliable for the purposes of this report.

To describe the permissible activities and regulatory safeguards for ILCs as compared with state nonmember banks, we reviewed federal and state legislation, regulations, and other guidance regarding ILCs and banks. We interviewed state bank regulators from the Utah Department of Financial Institutions, the California Department of Financial Institutions, and the Nevada Financial Institutions Division. We focused on ILCs and regulators in these three states because over 99 percent of the ILC industry assets exist in these states. We also interviewed key management officials of various ILCs in these states that were representative of the various sizes and business strategies, including: large businesses with activities that were predominantly within the financial services sector; businesses that were primarily credit card operations; captive financing arms of commercial holding companies; and a small, community-oriented banking institution. In addition, we interviewed management officials from the headquarters of FDIC, as well as field staff from FDIC's San Francisco Regional Office and the FDIC Salt Lake City Field Office that are responsible for the supervision of ILCs located in California, Nevada, Utah, and other states. We also interviewed officials from the Board of Governors of the Federal Reserve (Board).

To compare FDIC's supervisory authority over ILC holding companies and affiliates with the consolidated supervisors' authority over holding companies and affiliates, we analyzed legislation and regulations that govern the supervision of insured depository institutions, including ILCs and their holding companies, banks and their holding companies, and thrifts and their holding companies. We focused our comparison from a

safety and soundness perspective primarily on the Board's consolidated supervision of bank holding companies and their affiliates because these entities may pose similar risks to insured depository institutions as ILCs that exist in a holding company structure. However, because the Office of Thrift Supervision (OTS) also supervises similar entities that pose similar risks to insured depository institutions, we also reviewed OTS' supervisory authority. We also interviewed state banking regulators in California, Nevada, and Utah, as well as officials headquartered in the offices of the FDIC, the Board, and OTS who are knowledgeable of the supervisory approach and authorities of these agencies.

To determine recent changes FDIC has made to its supervisory approach for the risks that holding companies and affiliates could pose to ILCs and whether differences in supervision and regulatory authorities pose additional risk to the Fund, we interviewed knowledgeable FDIC officials and obtained documentation regarding revised agency guidance on safety and soundness examination procedures. We also compared agency examination manuals and other guidance; interviewed agency officials regarding the supervisory approach and supervisory authority of FDIC, the Board and OTS; and spoke with state and FDIC regional staff responsible for conducting examinations. Additionally, we synthesized and relied, as appropriate, upon information from the FDIC Inspector General (FDIC-IG) September 30, 2004, report entitled, *The Division of Supervision and Consumer Protection's Approach for Supervising Limited-Charter Depository Institutions* because this report provided information on FDIC's guidance and procedures for supervising limited charter depository institutions, including ILCs, and summarized various recent actions that FDIC had taken. Prior to relying on the FDIC-IG's report, we performed various due diligence procedures that provided a sufficient basis for relying upon their work including obtaining information about the other auditors' qualifications and independence; reviewing the other auditors' external quality control review report; and determining the sufficiency, relevance, and competence of the other auditors' evidence by reviewing the audit report, audit program and documentation. We also reviewed and synthesized information from the FDIC-IG's material loss reviews of Pacific Thrift and Loan and Southern Pacific Bank, two failed ILCs. To determine what actions FDIC had taken as a result of these material loss reviews and any other conditions existing in the banking industry at that time, we interviewed FDIC management about the status of recommendations made by the FDIC-IG in the material loss reviews.

To determine whether ILCs allow for greater mixing of banking and commerce than other insured depository institutions and whether this possibility has any competitive implications, as well as to determine the implications of granting ILCs the ability to pay interest on business checking accounts and operate de novo branches nationwide, we reviewed and synthesized academic, bank regulator, and other studies and literature about the historic policy of mixing banking and commerce, potential economies of scale and scope in the banking industry, and academic literature on mixed banking and commerce in other countries. We also interviewed and reviewed studies from academics who have published on the subject of regulatory and competitive issues in the banking industry. Additionally, we reviewed applicable laws and legislative proposals, press reports, and other documents. Furthermore, we assessed the degree to which other depository institutions are able to mix banking and commerce, such as unitary thrifts, “nonbank banks,” merchant banks, and captive finance subsidiaries. In addition, we reviewed applicable laws and regulations and interviewed federal banking regulators from the FDIC, Federal Reserve, and OTS. We also interviewed state banking regulators in Utah, California, and Nevada and key management officials from several ILCs in California, Nevada, and Utah, as well as representatives from the Independent Community Bankers Association.

Finally, to more fully understand (1) the significance of the differences between consolidated supervision of bank and thrift holding companies and FDIC’s supervision of ILCs and the potential risks that their holding company and affiliate organizations may pose to the ILC, (2) the potential for greater mixing of banking and commerce by ILC holding companies as compared with other types of depository institutions, and (3) the potential advantages and disadvantages of granting ILCs the ability to pay interest on business checking accounts and open de novo branches nationwide, we hosted a panel of experts. The panel members were selected from a list of well-known and knowledgeable officials from the FDIC and the Board, academics, economists, industry practitioners, and independent consultants. The panel participants were selected to ensure a robust discussion of divergent views on issues facing the ILC industry and bank regulators.

# Comments from the Board of Governors of the Federal Reserve System



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

ALAN GREENSPAN  
CHAIRMAN

August 19, 2005

Mr. Richard Hillman  
Director  
Financial Markets and Community Investment  
United States Government Accountability Office  
Washington, D.C. 20548

Dear Mr. Hillman:

The Board appreciates the opportunity to review and comment on the Government Accountability Office's (GAO) draft report concerning industrial loan companies (GAO-05-621). The Board concurs with and strongly supports the GAO's conclusions.

ILCs are state-chartered, FDIC-insured banks that were first established in the early 1900s to meet the borrowing needs of local industrial workers. Your report notes that the ILC industry has changed dramatically in recent years. As the report states, the laws of some states "have essentially placed ILCs on par with other FDIC-insured state banks" in terms of permissible powers. In addition, the total assets held by ILCs have grown by more than 3,500 percent between 1987 and 2004, and six ILCs are now among the largest 180 banking organizations in the country.

A special exemption in current law, however, allows any company, including a commercial firm or foreign bank, to acquire an ILC in a handful of states (principally Utah, California, and Nevada) and avoid the consolidated supervisory requirements and activity restrictions that apply to the corporate owners of other types of insured banks under the federal Bank Holding Company Act (BHC Act). Consolidated supervision provides important protections to the insured banks that are part of a larger organization as well as the federal safety net that supports those banks. For this reason, the BHC Act and other federal law grant the Board broad authority to examine and obtain reports from bank holding companies and their subsidiaries, establish consolidated capital requirements for bank holding companies, and take supervisory or enforcement action against a bank holding company or its nonbank subsidiaries to address unsafe or unsound practices before these practices pose a danger to an affiliated bank.

The report also notes that current legislative proposals that would grant exempt ILCs the authority to open de novo branches on an interstate basis, or offer

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Appendix II  
Comments from the Board of Governors of  
the Federal Reserve System

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Mr. Richard Hillman  
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interest-bearing checking accounts to business customers, would make it increasingly attractive for companies to establish ILCs, rather than other types of insured banks, and thus avoid consolidated supervision. In addition, because ILCs are exempt from the definition of “bank” in the BHC Act, a foreign bank may acquire an FDIC-insured ILC without meeting the requirement in the BHC Act that the foreign bank be subject to comprehensive supervision on a consolidated basis in its home country. Congress established this comprehensive, consolidated supervision requirement in 1991 for foreign banks seeking to enter the banking business in the United States following the collapse of Bank of Commerce and Credit International (BCCI).

Your report also properly highlights the broad policy implications that ILCs raise with respect to maintaining the separation of banking and commerce. Because Congress has closed the so-called “nonbank bank” and unitary thrift loopholes, the ILC exemption is now the primary means by which commercial firms may control an FDIC-insured bank engaged in broad lending and deposit-taking activities. We believe it is important for the Congress to decide, after a full and careful evaluation, whether broader mixings of banking and commerce should be allowed for all banking organizations, rather than allowing the nation’s policy on banking and commerce to be decided de facto through the exploitation or expansion of an exemption available only to one type of institution chartered in certain states.

Board staff has separately provided GAO staff technical and correcting comments on the draft report. We hope that these comments are helpful.

Thank you again for your efforts on this important matter.

Sincerely,

A handwritten signature in black ink, appearing to be "Alan Steinberg", written over the word "Sincerely,".

# Comments from the Federal Deposit Insurance Corporation



FEDERAL DEPOSIT INSURANCE CORPORATION, Washington DC 20429

DONALD E. POWELL  
CHAIRMAN

August 29, 2005

Mr. Richard Hillman, Director  
Financial Markets and Community Investment  
U.S. General Accounting Office  
441 G Street, N.W.  
Washington, D.C. 20548

Dear Mr. Hillman:

Thank you for the opportunity to comment on the draft report entitled *Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlights Differences in Regulatory Authority (GAO-05-621)*. Your report does not recommend executive action. However, we welcome this opportunity to respond to the report and address the Matters for Congressional Consideration that you have raised.

The Federal Deposit Insurance Corporation agrees with the report's finding that "from an operations standpoint, industrial loan corporations (ILCs) do not appear to have a greater risk of failure than other types of insured depository institutions." The report also documents the FDIC's legal and supervisory authorities to address risks to insured ILCs that may be posed by affiliated entities. The report nevertheless recommends that Congress consider strengthening (the report's term) the regulation of parent companies of ILCs by subjecting them to the same consolidated supervision as is currently applied to bank holding companies. The FDIC believes these suggested changes in regulation are unnecessary from a safety and soundness perspective, and would inappropriately change the relationship between the federal banking agencies and the non-bank sector of the U.S. economy.

As outlined in more detail in this letter, the FDIC does not believe that consolidated supervision of an ILC's corporate owner is necessary to ensure the safety and soundness of the ILC itself. The FDIC disagrees with the GAO's finding that our regulatory authorities may not be sufficient to effectively supervise, regulate, or take enforcement action to insulate insured institutions against undue risks presented by external parties. We believe the GAO's finding is founded on a misinterpretation of the legal basis underlying the regulatory authorities of both the FDIC and the Federal Reserve Board of Governors (Federal Reserve). The core of each banking agency's statutory mandate for supervision is preserving the safety and soundness of insured depository institutions. We believe the record shows the FDIC's authorities are as effective in achieving this goal as are the authorities of consolidated supervisors.

The FDIC also believes consolidated supervision of ILC parents would change the relationship between the federal banking agencies and the non-bank sector of the U.S. economy in undesirable ways. This includes the potential for an unintended expansion of the federal

banking safety net, and the costs of imposing bank-like regulation on a greater share of U.S. economic activity. The GAO bases its recommendations in part on the idea that ILCs benefit from an uneven competitive playing field, since their parent companies are not subject to the same type of consolidated supervision that applies to other corporate owners of insured banks. As noted by a number of panelists at a symposium the GAO convened to assist in the preparation of this report, however, there are reasons why commercial and other non-bank owners of insured banks should not be subject to consolidated banking agency supervision. Commercial firms and entities such as broker-dealers are, and should remain, outside the scope of the federal banking safety net. Imposing activity restrictions and other aspects of bank-like regulation on firms that historically have not been subject to such regulation has costs, and these costs need to be weighed against any perceived safety-and-soundness benefits to insured entities.

The necessity of consolidated federal supervision of all large conglomerates that own banks is a new idea. In March, 1997, Federal Reserve Chairman Alan Greenspan told Congress:

...we would hope that should the Congress authorize wider activities for financial services holding companies that it recognize that a bank, which is a minor part of such an organization (and its associated safety net), can be protected through adequate bank capital requirements and the application of Sections 23A and 23B of the Federal Reserve Act. The case is weak, in our judgment, for umbrella supervision of a holding company in which the bank is not the dominant unit and is not large enough to induce systemic problems should it fail.<sup>1</sup> [Emphasis added].

More recently, proponents of consolidated supervision appear to have moved away from the views expressed by Chairman Greenspan and toward a more absolute claim that the safety and soundness of an insured financial institution requires the consolidated, top-down supervision of its corporate owner. This approach, which the GAO endorses, is based on the idea that supervisors should mirror business processes used in the private sector. Enterprise risk management processes, used by a number of large banking organizations, are characterized by a centralized approach to risk management throughout the conglomerate. Enterprise risk management, as used in these firms, is essentially a tool to better manage private profits and safeguard the interests of holding company shareholders. However, its use as a model on which federal bank supervisors would base their efforts to safeguard individual insured banks within large conglomerates is as yet unproven. Indeed, by appearing to promote the operation of insured entities in conglomerates more as integrated parts of a broader organization, and less as insulated entities, consolidated supervision going forward could have the unintended effect of extending the scope of the safety net, rather than containing it.

For these reasons, the FDIC believes that a supervisory approach that focuses on insulating the insured financial institution and the federal safety net from external risks (the bank-centric approach) is an appropriate supervisory model for ILCs and their parent companies.

<sup>1</sup> Testimony of Chairman Alan Greenspan before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the Committee on Banking and Financial Services, U.S. House of Representatives, March 19, 1997.

The remainder of this letter provides further discussion of the track record of supervision, the practical significance of differences in agencies' supervisory authorities, certain issues related to banking agency supervision of commercial firms, and the scope of the federal banking safety net.

#### **The Track Record of Supervision**

Surprisingly, in recommending one mode of supervision over another, the report attempts no comparison of how these methodologies have fared in protecting the deposit insurance funds, or their relative costs and benefits. Not only does the report attempt no systematic study of these issues, it ignores opportunities for relevant comparisons. For example, while acknowledging that the FDIC successfully insulated from failure the insured ILC of a large, bankrupt, commercial parent company, the report does not provide similar examples where a large bank holding company failed without any losses to its insured subsidiaries.

In the absence of any factual comparison of how various models of holding company supervision have fared in protecting the deposit insurance funds, the GAO report looks to a single ILC failure, Pacific Thrift and Loan (PTL), and repeats assertions by representatives of the Federal Reserve who speculate that excessive debt at PTL's parent caused the bank to engage in higher-risk strategies that resulted in the bank's failure. The assertions, however, are not supported by the FDIC Inspector General's Material Loss Review finding that, "PTL's overly optimistic valuation assumptions resulted in inflated values that were unrealizable." PTL did not fail as a result of parent company debt, and neither the Federal Reserve nor the GAO presents any evidence that an examination of the parent company by a consolidated supervisor would have prevented the failure of this insured institution. The Federal Reserve's assertions in this case are all the more surprising in view of the fact that it joined the FDIC and other bank regulators in responding to the failure of PTL and other non-ILC institutions by tightening the rules for valuations of residual assets, not by taking any action to address problems with excessive parent company debt.

The FDIC believes that bank-centric supervision, as applied by the National Bank Act and the FDI Act, and enhanced by Sections 23A and 23B of the Federal Reserve Act and the Prompt Corrective Action provisions of the FDIC Improvement Act, is a proven model for protecting the deposit insurance funds, and no additional layer of consolidated federal supervision of ILC parents is necessary.

#### **The Legal Authority for Supervision**

The FDIC's supervisory philosophy of insulating the insured ILC, bank, or thrift, is rooted in the absolute accountability of insured institution boards of directors for the governance of their institutions. Transaction testing at the insured entity, traced as needed through parent companies and affiliates, is intended to ensure that undue parent company influence is not being exercised. Important bank functions are evaluated onsite, whether at the bank or, where those functions are outsourced to affiliates, at those entities. Identifying and addressing inappropriate influence by affiliated entities is included in the scope of every examination, but the degree of insulation the FDIC requires increases substantially as identified risk increases, and can reach the

point where the bank is completely walled off from its affiliates with all major decisions requiring FDIC approval.

One of the central themes of the report is that the FDIC's authority to examine an affiliate of an insured depository institution is so restricted that reputation risk from an affiliate that has no direct relationship with the ILC could go undetected. Contrary to GAO's legal interpretation, the FDIC's affiliate examination authority is not dependent upon the existence of any particular kind of relationship, nor is it limited to discrete transactions between an ILC and its affiliate. The FDIC does not agree that its examination authority is properly interpreted so narrowly. In actual application, even in problem-institution or failure cases, the FDIC has always been able to exercise its examination authority broadly enough to fulfill its supervisory duties.

The GAO report points to perceived limitations on the FDIC's supervisory authority that might prevent it from exercising authority over certain non-banking affiliates. Yet, a careful reading of the report reveals that the authorities of consolidated supervisors are subject to almost identical limitations. Furthermore, the GAO report acknowledges an additional power available to the FDIC alone: "[a]s demonstrated by the number of institutions that took measures to enhance the safety and soundness of the insured depository institution, the threat of insurance termination has been an effective supervisory measure in many instances."

Whether in the case of a consolidated supervisor or the FDIC, the financial institution supervisor must rely on knowledge of a potential problem at a non-bank subsidiary and have some reason to believe that problem may adversely affect the insured depository institution before the supervisor can take direct action. The FDIC has an excellent track record of doing so even without the consolidated supervisory powers itemized in the report. In terms of the relevant goal of safeguarding the federal banking safety net, any conclusion that the FDIC's affiliate examination authority is less effective in practice than that of consolidated supervisors is not supported by the historical record.

#### **Issues Associated with Banking-Agency Supervision of Commercial Enterprises**

Consolidated supervision implies that a federal banking regulator would oversee the commercial parent and its affiliates, and that commercial activities increasingly would be subject to regulation designed for banks. The potential result of implementing the GAO's recommendation would be that federal banking regulators may exercise supervisory oversight over large sectors of the U.S. economy. This would represent a new level of government intrusion in the marketplace – in fact, it would amount to a radical restructuring of the longstanding role of the federal government relative to commercial firms. Such an approach also would raise significant concerns about legal separateness, corporate governance, and the unwarranted expansion of the federal safety net.

It should also be noted that consolidated supervision of a large, commercial organization is subject to certain practical constraints. The legal structures of many of these companies are intentionally segregated, with some large companies having hundreds of subsidiaries. Many financial holding companies are similarly diverse. An individual review of each subsidiary would be extremely time-consuming and would be unlikely to yield information useful to the

effective supervision of the subsidiary bank. As a result, consolidated supervisors have tended to focus on a high-level review as the only time-effective, practical approach to the supervision of these entities. The argument that consolidated supervision of a company such as General Electric would benefit bank regulators by improving familiarity with a non-bank affiliate, such as the consumer electronics division of the company, is not compelling from either a logistical or a risk identification standpoint.

**The Consolidated Supervision Approach May Extend the Federal Safety Net**

In the United States, the federal safety net is provided to insured banks, not their holding companies and affiliates. Preventing the federal safety net from supporting risks taken outside insured banks has been the most often-stated reason for the existence of bank holding company supervision.

Recently, however, the Federal Reserve endorsed the concept of enterprise-wide supervision, founded on the principle that government supervision must mirror the manner in which companies are managed. The FDIC is concerned that some aspects of this new supervisory approach may detract from achieving the traditional goal of preventing insured entities from supporting risks taken in parents or affiliates. Under an enterprise-wide supervision approach, it appears that the supervisory vision of an insured bank as an independent entity may be supplanted by a supervisory vision of an insured bank as an integrated component of a larger organization. Enterprise supervision by holding company management, and the top-down approach to Basel II advocated by the Federal Reserve, have the potential to call into question the individual accountability of insured institutions owned by large organizations to manage their own capital.

A supervisory goal of insulating an insured bank from risks taken by an affiliate is fundamentally different from a supervisory goal of integrating that bank with its affiliates. Integration downplays the risk-management responsibilities of insured entities operating in financial conglomerates. A supervisory regime that in any way supports the idea that insured banks are not fully accountable for their own risk management, combined with a capital regime that promotes the concept that an insured institution's risk should be measured together with its affiliates, effectively expands the federal safety net.

The regulatory approach of the FDIC focuses on the insured entity and the importance of maintaining corporate separateness. The consolidated supervision model proposed by the GAO for consideration by Congress not only endangers these legal-entity distinctions, but also raises the possibility of extending the federal safety net beyond the insured entity. To the extent banks are integrated and managed as departments of their holding company, especially if regulators by means of their supervisory methodology are actively promoting this approach, there is a danger that the bank could be held liable for the debts or conduct of an affiliate. This piercing of the corporate veil seems far more likely under an "integration" philosophy of supervision than it does under an "insulation" philosophy.

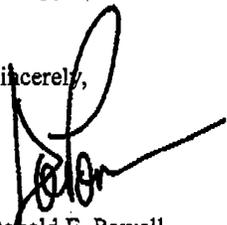
**Conclusion**

Congress must ensure that a financial regulatory framework is in place that adequately controls the potential cost of the federal banking safety net. This includes deciding how arrangements involving the ownership of banks by commercial firms should be regulated.

The GAO report articulated one vision of such regulation—consolidated banking agency supervision of the commercial parent. We are concerned with such an approach, and we believe the federal safety net is best protected in such situations by a bank-centric regulatory approach that focuses on bank insulation, corporate separateness, and the legal accountability of bank directors and officers.

The FDIC believes these issues will be an important subject for public policy debate in the years ahead. We stand ready to provide the GAO, Congress and other interested persons with any information we can in order to contribute to an appropriate resolution of these important questions.

Sincerely,



Donald E. Powell

# GAO Contact and Staff Acknowledgments

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## GAO Contact

Richard J. Hillman (202) 512-8678

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The following individuals made key contributions to this report:

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Marc Molino  
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