

Embargoed until  
April 25, 2007, at 10:00 am

Statement of

John M. Reich, Director,  
Office of Thrift Supervision

concerning

**Industrial Loan Companies**

before the

Committee on Financial Services  
United States House of Representatives

April 25, 2007

Office of Thrift Supervision  
Department of the Treasury

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**I. Introduction**

Good morning, Mr. Chairman, Ranking Member Bachus, and Members of the Committee. Thank you for the opportunity to address issues related to the activities, ownership and control of industrial loan companies (ILCs). In particular, I understand that you seek the Office of Thrift Supervision's (OTS) views on the supervision and oversight of savings and loan holding companies (SLHCs) that own and/or control ILCs. Finally, you seek comment on H.R. 698, the Industrial Bank Holding Company Act of 2007, which was introduced by you, Mr. Chairman, and Congressman Gillmor, on January 29, 2007.

Mr. Chairman, I wish to commend you, Mr. Gillmor and other Members of this Committee on the introduction of H.R. 698. It addresses several pending policy issues with respect to the key areas of the permissible activities and oversight of companies that own or control, or seek to acquire or control, an ILC. I applaud your leadership in addressing these important policy matters. For my part, I appreciate the recognition in H.R. 698 of the important role that the OTS has in overseeing and supervising several of the largest companies that currently own and control ILCs. As you know, functional

regulation and consolidated regulatory oversight have been important considerations in recent legislation supported by this Committee. H.R. 698 maintains this forward-looking focus on maintaining the enterprise-wide safety and soundness of holding companies that own or control institutions with access to the federal safety net.

If the concern is the potential exposure of the federal safety net to a company that owns or controls an ILC, then the issue is not one of who regulates the entity, but rather how best to understand and supervise the interrelationships within the structure and how the ILC is integrated. An effective holding company regulator oversees the parent holding company of an ILC or other insured depository institution without imposing draconian operating restrictions or other requirements. The OTS expects entities that it regulates to manage the risks within their operations. We use a risk-focused, top-down examination methodology that weighs a company's ability to manage these risks.

Effective oversight of holding companies requires having adequate government controls to monitor and intervene when necessary without unduly interfering with the ongoing business operations and activities of the enterprise. It is a delicate balance that requires judgment based on expertise in a wide range of areas. The OTS focuses and tailors its supervision of SLHCs based on the complexity of the structure and the level of risk inherent in the holding company enterprise. Comprehensive supervision of SLHCs is a combination of ongoing off-site monitoring, targeted reviews, and on-site examinations. This combined approach permits the OTS to gain an understanding of the business and its inherent risks, as well as the affiliations and the transactions of the

enterprise. It also enables us to assess the potential impact on the broader economy, the insured depository institution and the potential exposure to the federal safety net.

In order to understand the OTS's perspective on holding company oversight and its role in supervising companies that own or control ILCs, it is necessary to understand the development of the ILC structure, as well as how the OTS evolved as the supervisor of numerous ILC holding company structures.

## **II. Overview on the Development of ILCs and Current Demographics**

ILCs have existed since the early 1900s, when a number of small, state-chartered institutions formed to provide a source of unsecured loans to industrial workers who did not have access to financial services at traditional depository institutions. For many years, these small entities remained focused almost entirely, if not exclusively, on serving their existing customer base of industrial workers.

During the last 25 years, however, ILCs have grown considerably in size and number. This growth in assets and aggregate numbers was driven substantially by the eligibility of ILCs for federal deposit insurance in 1982. Also increasing the attractiveness of the ILC charter was legislation in 1987 that exempted companies that own ILCs from the ownership restrictions of the Bank Holding Company Act (BHCA). Pursuant to these statutory provisions, ILCs are state-licensed, insured depository institutions regulated by their respective state bank supervisor as well as the FDIC under

the Federal Deposit Insurance Act (FDIA). They are not considered “banks” under the BHCA.<sup>1</sup> As a result, ILCs are currently not subject to holding company oversight unless the parent company also owns or controls a bank or thrift. Similarly, ILCs are not currently prohibited from commercial affiliations, including being owned or controlled by a commercial company.

Today, although only a handful of states continue to charter ILCs, the charter is thriving. As of December 2006, there were 60 institutions holding more than \$213 billion in aggregate assets. While the five largest institutions dominate the industry, holding \$151 billion or roughly 71 percent of aggregate industry assets, 17 of the 60 institutions have assets in excess of \$1 billion. And as you are aware, interest in the ILC charter has never been higher. For various reasons, including interest by commercial

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1. Section 2(c)(2)(H) of the Bank Holding Company Act (12 U.S.C.A. § 1841(c)(2)(H)) provides that the term “bank” does not include “An industrial loan company, industrial bank, or other similar institution which is –

(i) an institution organized under the laws of the State which, on March 5, 1987, had in effect or had under consideration in such State’s legislature a statute which required or would require such institution to obtain insurance under the Federal Deposit Insurance Act [12 U.S.C.A. § 1811 et seq.] --

(I) which does not accept demand deposits that the depositor may withdraw by check or similar means for payment to third parties;

(II) which has total assets of less than \$100,000,000; or

(III) the control of which is not acquired by any company after August 10, 1987; or

(ii) an institution which does not, directly, indirectly, or through an affiliate, engage in any activity in which it was not lawfully engaged as of March 5, 1987,

except that this subparagraph shall cease to apply to any institution which permits any overdraft (including any intraday overdraft), or which incurs any such overdraft in such institution’s account at a Federal Reserve bank, on behalf of an affiliate if such overdraft is not the result of an inadvertent computer or accounting error that is beyond the control of both the institution and the affiliate, or that is otherwise permissible for a bank controlled by a company described in section 1843(f)(1) of this title.”

companies in chartering ILCs to perform various finance-related activities, applications continue to be filed with the FDIC by ILCs seeking federal deposit insurance.

H.R. 698 addresses the lack of clear statutory authority for a federal regulator of an ILC holding company that does not otherwise own a bank or thrift. From a policy standpoint, it is our view that the Frank-Gillmor bill, as introduced, achieves all of its intended objectives.

As the discussion of this legislation unfolds, the OTS is particularly interested in maintaining the status quo for SLHCs that own ILCs. A number of prominent companies fall into this category. I appreciate the recognition in H.R. 698 of OTS's continued role as the prudential holding company regulator of these entities. In my experience, understanding the organizational structure and culture of each regulated institution is crucial to effective oversight of the enterprise and protection of the federal safety net. It is also essential to supervise all aspects of the affiliations with the insured depository institution, including inter-company transactions. We have significant experience performing strong consolidated supervision over some of the most complex firms in the world. The OTS appreciates the deference shown in the bill to our holding company supervision program.

### **III. OTS Oversight of ILCs in SLHC Structures**

As of December 31, 2006, there were eight ILCs within OTS-regulated SLHC structures. These ILCs had aggregate assets of \$142 billion or almost 67 percent of all ILC assets. In fact, six of the ten largest ILCs are owned or controlled by OTS-regulated SLHC structures. These six ILCs hold aggregate assets of \$138 billion, accounting for roughly 73 percent of the assets of the ten largest ILCs.<sup>2</sup> And of the top 15 ILCs,<sup>3</sup> the OTS regulates SLHCs that own or control eight. These eight institutions hold assets of \$142 billion, representing 71 percent of the assets of the 15 largest ILCs. The OTS is an active holding company supervisor of these eight institutions.

Pursuant to the Home Owners' Loan Act (HOLA), when a company controls both a savings association and an ILC, not only is the SLHC itself subject to OTS examination, so is the ILC. Although the HOLA excepts "banks" from OTS SLHC examination authority, the HOLA defines banks with respect to the BHCA. Since ILCs are not banks for purposes of the BHCA, ILCs controlled by SLHCs are subject to OTS examination. As detailed below, OTS supervision of SLHCs, including SLHC parents of ILCs, is statutory, comprehensive, risk-focused, and inclusive of the views of all relevant functional supervisors.

In connection with OTS oversight of SLHCs that own ILCs, the OTS is able to participate in examinations of the ILC by the state regulatory authority and/or the FDIC.

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2. The ten largest ILCs held assets of almost \$190 billion, accounting for approximately 89 percent of aggregate ILC industry assets.

3. The 15 largest ILCs held assets of \$201 billion, accounting for approximately 94 percent of aggregate ILC industry assets.

The OTS determines its level of participation in consultation with each ILC's relevant functional supervisor on a case-by-case basis. In each case, our goal is to ensure adequate oversight and coordination, while creating minimal regulatory overlap. Similarly, we coordinate our oversight and examinations of SLHCs to ensure that examiners exchange adequate and sufficient information with applicable state and/or FDIC staff and, when appropriate, other functional regulators.

#### **IV. OTS Authority and Supervision of SLHCs**

The OTS supervises a diverse population of holding companies. These range from non-complex companies with limited activities to large, internationally active conglomerates that engage in numerous, diverse activities and an array of domestic and international transactions. In connection with our strong statutory oversight and supervision of SLHCs and their subsidiary savings institutions, we have a well-established supervisory program for discharging the responsibilities assigned to us by law. Holding company supervision is an integral part of this oversight program and enables us to ensure risk-focused oversight of the entities that own or control licensed thrift institutions.

The OTS's holding company oversight program appropriately balances the need for effective supervision with the interests of a holding company enterprise to avoid excessive regulatory intrusion in its affairs. We focus on the company's capital and earnings, risk management framework, and governance structure. We evaluate the



oversight provided by the board of directors, and the effectiveness of holding company management at all levels. We also continually review key risk control functions, such as the enterprise's risk management framework, the internal audit function and the major risk concentrations and transactions that occur within the consolidated entity.

Our program is designed to understand how the company conducts business and manages risk throughout the enterprise. This understanding allows us to accurately assess the financial condition and risk profile of the holding company enterprise. It also enables us to consider the impact of the enterprise on insured depository subsidiaries or other regulated financial companies within the structure. Our program is designed to provide constructive and substantive feedback on these critical issues to boards of directors and management.

As noted above, OTS's authority as the primary supervisor of consolidated SLHCs is set forth in the HOLA. Pursuant to this authority, any company that proposes to acquire a thrift, and thereby become a SLHC, is subject to a statutory licensing (authorization) process that requires us to make numerous statutory findings.

In addition, the OTS has full legal, examination, and enforcement powers over savings associations, SLHCs, thrift subsidiaries, and third-party contractors performing services for, or conducting activities on behalf of, any of these entities. In particular, the HOLA provides that SLHCs and each subsidiary thereof (other than a bank) are subject

to OTS examination.<sup>4</sup> This authority includes the ability to examine and oversee any activity or entity in a SLHC structure, as well as to take enforcement action when appropriate.

In exercising its statutory oversight authority, the OTS works cooperatively with sectoral and functional regulators, including other federal and state banking agencies, as well as state insurance and federal securities supervisors. We also coordinate with various international financial supervisors on the supervision and oversight of internationally active SLHCs and their affiliates and subsidiaries. Due to our extensive communication and coordination with other supervisory agencies, we have information sharing, coordination, and confidentiality agreements with more than 60 domestic and international supervisors.

In addition, our supervisory program has achieved equivalency status from the European Union for three firms – an industrial conglomerate, a global insurance firm, and an international securities firm. The OTS’s status as a consolidated supervisor necessitates extensive contact with the domestic and international supervisory community for these and other internationally active complex firms supervised by the OTS.

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<sup>4</sup> The Gramm-Leach-Bliley Act imposed certain limitations on the OTS's ability to examine functionally regulated subsidiaries.

In carrying out its statutory holding company authority, the OTS conducts an extensive supervisory program. SLHCs are subject to reporting and examination requirements defined by the OTS. In this regard, we tailor information requests and examinations to address the specific issues and risks at an institution and/or a SLHC. Examiners conduct holding company examinations concurrently with the statutorily mandated schedule for annual (or 18-month) examinations of thrifts.

The OTS also follows a continuous supervision program at the largest and most complex thrifts and SLHCs. This continuous supervisory program includes developing a risk assessment, a supervisory plan, and conducting targeted reviews of high-risk areas. We also coordinate with functional regulators, and routinely meeting with senior management and the boards of directors of the thrift or SLHC and its subsidiary organizations.

The OTS follows a risk-focused, top-down examination approach at all SLHCs. It analyzes the parent holding company and material subsidiaries for their impact on the SLHC structure. There is particular scrutiny on the extent of any direct and/or indirect adverse finding that may affect the subsidiary thrift institution. This includes a review of intra-group transactions and risk concentrations in order to assess material transactions between affiliated entities. We also determine which business lines present the greatest potential risk to the SLHC, on a consolidated basis, and its subsidiary savings association.

Our holding company procedures are centered on an enterprise-wide assessment of the Capital, Organization Structure, Relationship, and Earnings/Liquidity of the holding company structure. This “CORE” examination approach is designed for understanding, analyzing, and evaluating a firm’s risk appetite and its approach to risk management. The more complex the firm, the more comprehensive our review and assessment of its risk profile and the effectiveness of its risk control functions.

The OTS works to reduce regulatory burden and redundant supervision by working cooperatively with other functional supervisors (e.g., the FDIC, Utah State Banking Department, Securities and Exchange Commission, etc). For example, we obtain copies of examination reports for material subsidiaries. Other examples of our coordination with other supervisors include:

- Hosting annual supervisors’ meetings on financial conglomerates for all supervisors with material business subsidiaries in the conglomerate to discuss common trends, findings, or violations.
- Routine communications with the FDIC and state bank supervisors regarding ILCs within SLHC structures. In this regard, the OTS relies on the expertise and examinations of these functional regulators, rather than conducting its own examination of each material entity. If there is a material problem emerging within an ILC that could affect the holding company enterprise, the OTS works closely with the functional regulator to minimize the impact on the enterprise and/or the OTS-regulated thrift subsidiary.

- Cooperating extensively with the FDIC and the State of Utah on several information technology examinations of SLHCs with ILC subsidiaries. In connection with these exams, each regulator appointed a central point of contact for each firm, with quarterly meetings to discuss examination strategy and planning.
- Obtaining and reviewing copies of SEC filings, audit reports, rating agency reports, and internal management reports (all of which generally include analysis of the ILC subsidiary if it is a material portion of the enterprise).
- Obtaining the most recent examination reports for an ILC when the OTS conducts a holding company examination. When the ILC reports indicate a significant weakness or concern, we follow up with the primary regulator. If the examination reports do not reveal any concerns, we incorporate the review and findings as part of its risk-focused examination approach.

Finally, the Government Accountability Office (GAO) confirms that the OTS has a strong and internationally recognized consolidated holding company supervision regime. We have worked hard in recent years to ensure that this program is up to the task of supervising the complex and internationally active SLHCs subject to our oversight.

Among the factors stressed by the GAO with respect to consolidated supervisory oversight is the importance of interagency collaboration. As noted above, this is an area in which the OTS is particularly aggressive, with outreach to both domestic and

international supervisors to ensure the agency can incorporate the views of all functional regulators into its examination reports.

OTS's consolidated holding company oversight program is a viable model for SLHCs with diverse and wide-ranging activities and operations. It is a model that also accommodates the various and sometimes competing interests that exist within holding companies that own or control other companies engaged in functionally regulated activities and that own or control an insured depository institution, including an ILC.

## **VI. Comprehensive Consolidated Supervision Standards**

I also want to address a provision currently being discussed as an amendment to H.R. 698. This provision would provide that if any foreign bank acquires an ILC, the Board of Governors of the Federal Reserve System (FRB) would make a determination, in consultation with the FDIC, that the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in the bank's home country.

The OTS believes it is appropriate to include a comprehensive consolidated supervision (CCS) standard in connection with a foreign bank's acquisition of an industrial bank. The BHCA imposes a CCS standard in connection with the FRB's review of an acquisition of a bank (as defined in the BHCA) by a foreign bank.

Similarly, the HOLA requires that OTS make a CCS determination whenever a foreign bank proposes to acquire a savings association.<sup>5</sup> While we support a new CCS determination for a foreign bank that is an existing depository holding company, if the holding company is a SLHC then the OTS is the appropriate regulator to make the CCS determination.

In such a case, the foreign bank/SLHC is already subject to OTS supervision, and OTS is already coordinating with foreign supervisors in connection with its supervision of the holding company. Given that OTS made the previous CCS determination with respect to the foreign bank, and OTS regulates – and will continue to regulate -- the foreign bank as an SLHC, the OTS believes that it, and not the FRB, should make the CCS determination in these cases.<sup>6</sup>

The OTS has the requisite expertise to make the CCS determination. OTS has been required to make CCS determinations regarding acquisitions of thrifts by foreign banks since 1991.<sup>7</sup>

In implementing the CCS approval standard, OTS regulations<sup>8</sup> provide that OTS will consider the same standards that the FRB applies in making CCS determinations.<sup>9</sup>

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<sup>5</sup> Section 10(e)(2)(D) of the HOLA, 12 U.S.C. § 1467a(e)(2)(D).

<sup>6</sup> Such a result is consistent with section 10(e)(2)(D) of the HOLA, which requires a separate CCS determination be made each time a foreign bank acquires a savings association.

<sup>7</sup> The approval standard relating to CCS was imposed by section 211 of the Federal Deposit Insurance Corporation Improvement Act of 1991, P.L. 102-242 (Dec. 19, 1991).

<sup>8</sup> 12 C.F.R. § 574.7(c)(2)(iv) (2007).

<sup>9</sup> These standards are set forth at 12 C.F.R. § 211.24(c)(1)(ii) (2007).

Under these standards, the relevant issues regarding a CCS determination relate to the nature of the foreign bank's supervision, and are not dependent on the charter of the target U.S. depository institution.

One of the underlying purposes of the GLB Act, and various prior laws such as EGRPRA, was to reduce regulatory duplication. In a case involving an acquisition of an ILC by a foreign bank that is already a SLHC, the OTS is, and will continue to be, the consolidated regulator of the holding company structure. FRB participation in the process would add a layer of regulatory duplication with no discernable policy benefit.

If a foreign bank/SLHC pursues an acquisition of a bank or establishment of a branch in the United States, the resulting entity would be a BHC. In such instances, it is entirely appropriate for the FRB, as the resulting HC regulator, to conduct the CCS review. However, a situation involving a SLHC and an ILC is distinguishable. In the former cases, the FRB will have ongoing supervisory authority with respect to the holding company structure after the acquisition of the bank (or establishment of the bank branch). Where a foreign bank/SLHC acquires an ILC, the FRB will not have any ongoing supervisory authority after the transaction. In contrast, OTS will have had, and will retain, ongoing supervisory authority over the holding company structure. Thus, we believe that where the existing and resulting HC is a SLHC, the OTS is the appropriate U.S. regulator for the CCS determination.

## **VII. Conclusion**



The OTS has extensive experience overseeing SLHCs, including financial conglomerates and commercial holding company structures. The agency evaluates the consolidated holding company structure as well as the relationship between the insured depository institution and its affiliates. OTS supervision provides a strong and robust regulatory framework that oversees a SLHC's risk management platform, rather than dictating the course of conduct of the affairs and operations of the holding company. This approach ensures the flexibility these firms require to compete in a dynamic marketplace while providing a strong supervisory structure over their policies, procedures and activities.

We support Congressional efforts to address concerns with respect to the oversight of ILC holding company parents, recognizing that OTS currently exercises effective supervision of SLHCs that control approximately 67 percent of ILC industry assets nationwide. As currently drafted, H.R. 698 preserves existing OTS authority and oversight of these SLHCs that own or control ILCs; promotes functional regulation while promoting consolidated regulatory oversight of holding companies; and maintains a forward-looking, risk-based focus to oversee holding companies that own or control institutions with access to the federal safety net. For all these reasons, the OTS supports H.R. 698 as introduced by Chairman Frank, Congressman Gillmor, and the other Sponsors on the Committee. Thank you.

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