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INDUSTRIAL LOAN CORPORATIONS

Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority

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Why GAO Did This Study

Since their origin in the early 1900s, industrial loan corporations (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 testimony is based on our September 2005 report that, among other things, (1) described the growth and permissible activities of the ILC industry, (2) compared the supervisory authority of the FDIC—the current federal regulator for ILCs—with consolidated supervisors, and (3) described the extent to which ILC parents could mix banking and commerce.

In this testimony GAO is reiterating that Congress should (1) consider options for strengthening the regulatory oversight of ILCs and (2) more broadly consider whether allowing ILCs a greater degree of mixing banking and commerce is warranted or whether other entities should be permitted to engage in this level of activity.

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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.

What GAO Found

The ILC industry has experienced significant asset growth and has evolved from once small, limited-purpose institutions to a diverse industry that includes some of the nation's largest and more complex financial institutions. Between 1987 and 2006, ILC assets grew over 3,900 percent from $3.8 billion to over $155 billion. In most respects, ILCs may engage in the same activities as other depository institutions insured by the FDIC and are subject to the same federal safety and soundness safeguards and consumer protection laws. 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 present 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 or control other entities. Although FDIC has supervisory authority over an insured ILC, this authority does not explicitly extend to ILC holding companies and, therefore, is less extensive than the authority consolidated supervisors have over 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 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.

Because of an exception in federal banking law, ILC holding companies can mix banking and commerce more than the holding companies of most other depository institutions. In addition, there are a number of pending applications for deposit insurance with FDIC involving commercial firms, including one of the largest retail firms. 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 merits in Congress taking a look at whether ILCs or other entities should be allowed to engage in this level of activity.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the results of our 2005 report on industrial loan corporations (ILCs).[1] Over the past 10 years, ILCs, particularly when included as part of a holding company structure, have experienced significant growth, now having over $155 billion in assets; these once small niche lenders have evolved into a diverse industry that includes some large, complex financial institutions. As a result, some have expressed concerns that ILCs may be expanding beyond the original scope and purpose intended by Congress.

The potential entry into banking services by some of the nation's largest retailers has also raised concerns. In 2005, one of the world's largest retailer, Wal-Mart, submitted an application with the Federal Deposit Insurance Corporation (FDIC) to provide federal insurance of deposits in a subsidiary ILC. In May, Home Depot, the nation's largest home improvement retailer, submitted an application for FDIC to approve the purchase of an existing ILC. Proponents assert that these operations will benefit consumers through lower prices or increased access to financial services. Critics, however, say that nonfinancial operations of this size owning an insured ILC pose unnecessary risks to the deposit insurance funds that cannot be adequately addressed under the current regulatory authorities.

My remarks today are primarily based on our 2005 report and focus on three of the report's objectives: the growth and permissible activities of the ILC industry, how FDIC's supervisory authority over ILC holding companies and affiliates compares with a consolidated supervisors' authority; and, the extent to which the ILC charter enables commercial holding companies to mix banking and commerce.[2]

In summary:

ILCs began in the early 1900s as small, state-chartered, loan companies that primarily served the borrowing needs of industrial workers unable to

[1]GAO, *Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority*, GAO-05-621 (Washington, D.C.: September 15, 2005).

[2]In preparation for this hearing, we updated our September 2005 report to provide information on the number and total assets of ILCs through March 31, 2006.

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. For example, from 1987 to March 31, 2006, ILC assets have grown over 3,900 percent from $3.8 billion to over $155 billion. With one exception contained in federal and one state's banking laws, federally insured ILCs in a holding company structure may generally engage in the same activities as other FDIC-insured depository institutions. 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. As a result, from an operations standpoint, ILCs in a holding company structure pose risks to the Deposit Insurance Fund (the Fund) similar to those posed by other FDIC-insured institutions in holding company structures.[3]

ILCs are state chartered depository institutions. Concerns about them presently exist because of a provision in the Bank Holding Company Act (BHC Act). Under that act, a company that owns or controls a federally insured ILC can conduct banking activities through the ILC without becoming subject to the federal supervisory regime that applies to companies that own or control banks or thrifts. Because these ILCs have federally insured deposits, they are subject to supervision by FDIC as well as their respective state regulators.[4] However, FDIC lacks the explicit authority to regulate ILC parent companies and their activities. Under the BHC Act, the Board of Governors of the Federal Reserve (Board) is responsible for supervising 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.[5] The Office of Thrift Supervision has similar authority under the Home Owners Loan Act with

[3]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.

[4]Since ILCs are state-chartered financial institutions, they are subject to supervision and regulation by both FDIC and the chartering state's financial regulator.

[5] The Securities and Exchange Commission has approved the applications of five investment banks, including the parent companies of several large ILCs, to be subject to consolidated supervision.

respect to savings and loan holding companies. The Board and OTS each take a systemic approach to supervising depository institution holding companies and their nonbank subsidiaries and may look across lines of business at operations such as risk management, information technology, or internal audit in order to determine the risk these operations may pose to the insured institution. However, because of an exception under the BHC Act, holding companies of ILCs are not subject to consolidated supervision. Unlike the Board, FDIC does not have specific consolidated supervisory authority over holding companies that conduct banking activities only through ILCs. FDIC has, however, employed what some term 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. While FDIC's cooperative working relationships with state supervisors and ILC holding company organizations, combined with its other bank regulatory powers, has allowed FDIC, under certain circumstances, to assess and address the risks to the insured institution and to achieve other results to protect the insurance fund against ILC-related risks, questions remain about the extent to which FDIC's supervisory approach and authority address all risks posed to an ILC from its parent holding company and nonbank affiliates and how well FDIC's approach would fare for large, troubled ILCs during times of stress.

Another area of potential concern about ILCs is the extent to which they can mix banking and commerce through the holding company structure. The BHC Act maintains the historical separation of banking from commerce by generally restricting bank holding companies to banking-related or financial activities. [6] However, because of the ILC exemption in the BHC Act, ILC holding companies, including nonfinancial institutions such as retailers and manufacturers, and other institutions are not subject to federal activities restrictions. Consequently, they have greater latitude to mix banking and commerce than most other financial institutions. While some industry participants have stated that mixing banking and commerce

[6]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).

may offer benefits from operational efficiencies, the policy of separating banking and commerce was based primarily on reducing the potential adverse consequences that combining these activities may pose. These include the potential expansion of the federal safety net provided for depository institutions to their commercial holding companies or affiliates, increased conflicts of interest within a mixed banking and commercial conglomerate, and increased economic power exercised by large conglomerate enterprises. We found divergent views about the competitive implications of mixing banking and commerce and were unable to identify conclusive empirical evidence that documented efficiencies attributable to mixing banking and commerce. In addition, we found it unusual that use of the ILC exemption under the BHC Act would be the primary means for mixing banking and commerce across a broader scale than afforded to the holding companies of other federally insured depository institutions.

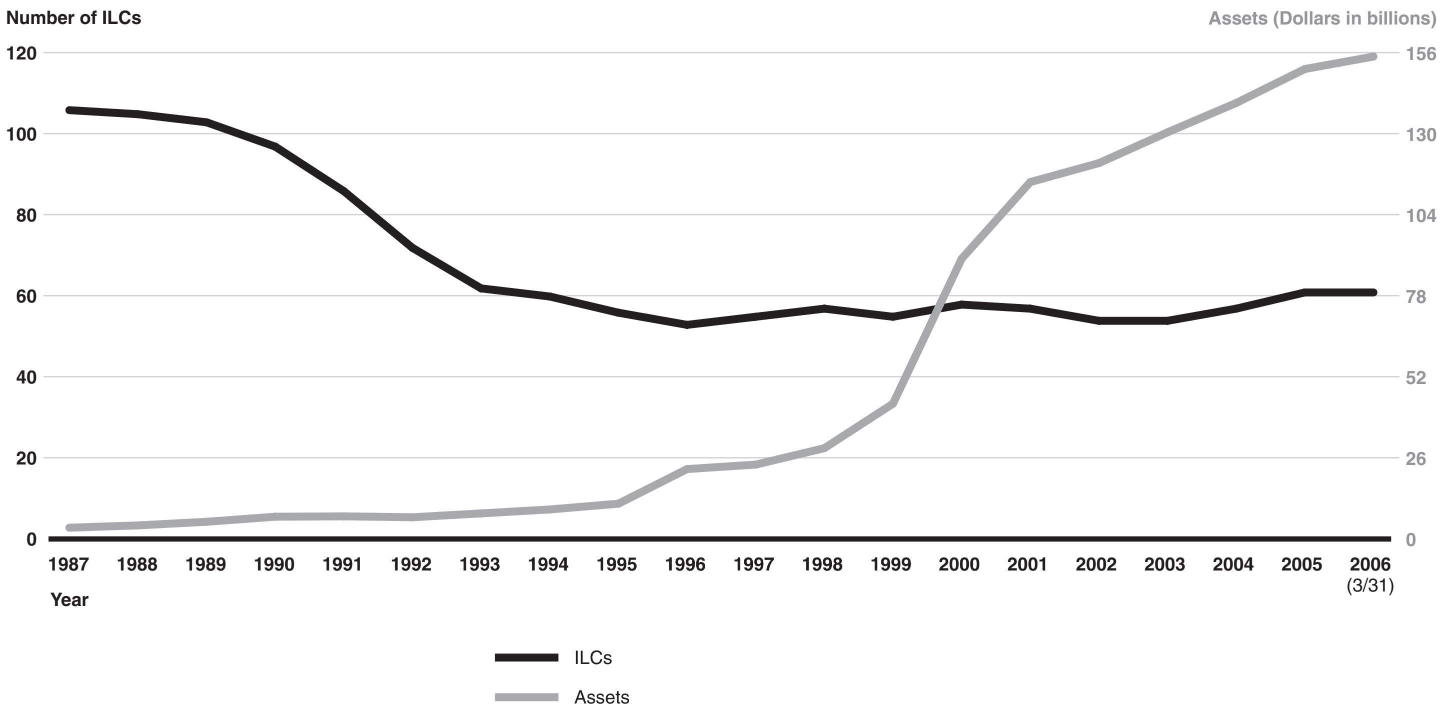
Our report included matters for congressional consideration designed to better ensure that insured institutions providing similar risks to the Fund are subject to federal supervision overseen by banking supervisors that possess similar powers. In this regard, we determined that it would be useful for Congress to consider several options such as eliminating the current BHC Act exception 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 concluded that it would also be beneficial for Congress to more broadly consider the advantages and disadvantages of mixing banking and commerce to determine whether allowing 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.

Before discussing the results of our work more fully, I would like to provide a brief overview of the growth of ILCs and compare their permissible activities with those of a state nonmember commercial bank.

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

First, I would like to highlight the significant growth and transformation that has taken place in the ILC industry since 1987. ILCs began in the early 1900s as small, state-chartered loan companies, serving the borrowing needs of industrial workers unable to obtain noncollateralized loans from commercial banks. Since then, the ILC industry has experienced significant asset growth and evolved from small, limited-purpose institutions to a diverse group of insured financial institutions with a variety of business models. Most notably, as shown in figure 1, from 1987 to March 31, 2006, ILC assets have grown over 3,900 percent, from $3.8 billion to over $155 billion, while the number of ILCs declined about 42 percent from 106 to 61. In March 2006, 9 ILCs were among the 271 largest financial institutions in the nation with $3 billion or more in total assets, and one institution had over $62 billion in total assets. As of March 31, 2006, 6 ILCs owned over 80 percent of the total assets for the ILC industry with aggregate assets totaling over $125 billion and collectively controlled about $68 billion in FDIC-insured deposits. 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, among the reasons ILCs grew in that state was because its laws are "business friendly," and the state offers a large, well-educated workforce for the financial services industry.

Figure 1: Number and Total Assets of ILCs, 1987 to March 31, 2006



Source: GAO analysis of FDIC Call Report data.

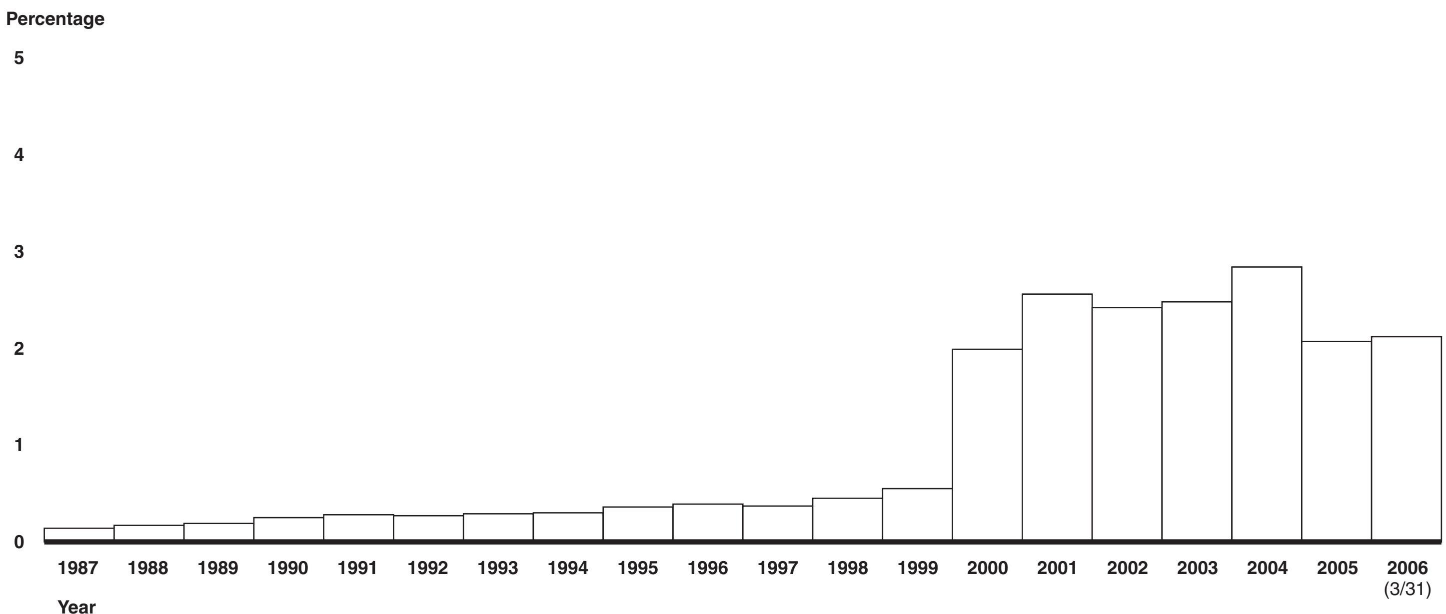
Financial services firms, such as the ILCs owned by Merrill Lynch, USAA Savings Bank, and American Express own and operate the majority of the 61 active ILCs.[7] These ILCs are parts of complex financial institutions with extensive access to capital markets. Other ILCs are part of a business organization that conducts activities within the financial arm of a larger corporate organization not necessarily financial in nature. In addition, other ILCs directly support the holding company organizations' commercial activities, such as the ILCs owned by BMW and Volkswagen. Finally, some ILCs are smaller, community-focused, stand-alone institutions such as Golden Security Bank and Tustin Community Bank.

Although the total amount of estimated insured deposits in the ILC industry has grown by over 600 percent since 1999, as shown in figure 2, these deposits represent less than 3 percent of the total estimated insured

[7]As of March 31, 2006.

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, as of March 31, 2006, the largest ILC, owned by Merrill Lynch, held over $43 billion in estimated FDIC insured deposits.

Figure 2: Percentage of Estimated FDIC Insured Deposits Held by ILCs, 1987 – March 31, 2006



Source: GAO analysis of FDIC Call Report data.

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

Next, I would like to briefly compare the permissible activities of ILCs with other insured financial institutions.[8] Federal banking law permits FDIC-insured ILCs to engage in the same activities as other insured depository institutions. However, in order to qualify for the ILC exception in the BHC Act, (and also, we found, because of restrictions in California state law) most ILCs, which are owned by non-BHC Act holding companies, may not accept demand deposits. Other than this exception,

[8] A full comparison is beyond the scope of this testimony. See our 2005 report for a more detailed and comprehensive discussion of ILC lines of business and the regulatory safeguards that apply to ILCs and other insured depository institutions.

banking laws in California, Nevada, and Utah have undergone changes that generally place ILCs on par with traditional banks in terms of services provided. Thus, as shown in Table 1, 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. [9] In effect, this permits ILCs offering credit cards to charge their state's maximum allowable interest rates in other states. [10] In addition, ILCs generally are subject to the same federal regulatory safeguards that apply to commercial banks and thrifts. For example, ILCs are subject to 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. [11] Sections 23A and 23B generally limit the dollar amount of loans to affiliates and require transactions to be done on an "arms-length" basis.[12] ILCs must also comply with Bank Secrecy Act, Anti-Money Laundering, and Community Reinvestment Act requirements and like other insured depository institutions comply with consumer protection laws.

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. The primary difference, as shown in table 1, between ILCs and other FDIC-insured depository institutions is that, to remain outside of the BHC Act, an ILCs must be chartered in the states described in the the

[9]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).

[10]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.

[11]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).

[12]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).

ILC exemption and may not accept demand deposits if its total assets are $100 million or more.[13]

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

Permissible Activities	State Non-member 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.[A]

Source: FDIC.

[A]ILCs can accept NOW accounts which are insured deposits that, in practice, are similar to demand deposits.

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.

Based on an analysis of the permissible activities of ILCs and other insured depository institutions, we and FDIC's Inspector General found that, from

[13]The Competitive Equity Banking Act (CEBA) contains the ILC exemption allowing entities that own or control ILCs to avoid Board regulations as a bank holding company. This exemption applies to ILCs chartered in states that as of March 5, 1987, had in effect or under consideration a statute requiring ILCs to be FDIC insured. According to the FDIC, at the time of the CEBA exemption, six states – California, Colorado, Hawaii, Minnesota, Nevada, and Utah met this requirement. Only ILCs chartered in these "grandfathered" states are eligible for the ILC exemption from the BHC Act.

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 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 their 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.

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

In our 2005 report we compared the supervisory approaches of FDIC and consolidated supervisors, such as the Board and the Office of Thrift Supervision (OTS), and described in detail several differences between FDIC's supervisory authority over ILC holding companies and affiliates and the authority of these consolidated supervisors. Today, I will highlight a few of these differences to illustrate how FDIC's authority over holding companies and affiliates is not as extensive as the authority that these consolidated supervisors have over holding companies and affiliates of banks and thrifts.

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. Organizations in countries throughout the world recognize consolidated supervision as an accepted approach to supervising organizations that own or control financial institutions and their affiliates. The European Union generally requires consolidated supervision for financial institutions operating in its member states, and the Basel Committee recognizes this

approach as an essential element of banking supervision.[14] 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 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 testimony, this approach is not as extensive as the consolidated supervisory approach in assessing the risks a depository institution faces in a holding company structure.

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

Because most ILCs exist in a holding company structure, they are subject to risks from the holding company and its subsidiaries, including adverse intercompany transactions, operations risk, 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. In our

[14]The Basel Committee on Banking Supervision, established in 1974, is composed of representatives from the central banks or supervisory authorities of major industrial countries in Europe, North America, and Asia, including the United States. 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.

2005 report, we described in detail various ways that consolidated supervision offered more explicit authority over holding company affiliates than FDIC's bank centric approach. Today, I will summarize two of these points to illustrate some of the differences in supervisory authority between the FDIC and consolidated supervisors. These two points describe differences in FDIC's and the Board's authority to examine holding companies and their nonbank subsidiaries to assess potential risks to the insured depository institution; and the importance of consolidated supervision standards designed to ensure that the holding company serves as a source of strength to the insured depository institution.

As consolidated supervisors, the Board and OTS have broad authority to examine bank and thrift holding companies (including their nonbank subsidiaries), respectively, in order to assess risks to the depository institutions that could arise because of their affiliation with other entities in a consolidated structure.[15] The Board and OTS have general authority to 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.[16] This authority is limited with respect to certain types of subsidiaries, such as those regulated by the Securities and Exchange Commission or state insurance regulators, but even those subsidiaries may be examined by the Board under appropriate circumstances 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 depository institution.[17] Also, under

[15]As noted above, the Securities and Exchange Commission has approved the applications of five investment banks, including the parent companies of several large ILCs, to be subject to consolidated supervision. This prudential supervision regime entails SEC oversight of the risk management and control systems and SEC examination of unregulated entities within the holding companies.

[16]See 12 U.S.C. §§ 1844(c)(2)(A), 1467a., and 12 U.S.C. § 1831v(b).

[17]See 12 U.S.C. § 1844(c)(2)(B).

the BHC Act, a Board examination of a holding company must, to the fullest extent possible, focus on subsidiaries that could have a materially adverse effect on the safety and soundness of the affiliated depository institution due to the subsidiary's size, condition or activities or the nature and size of transactions between the subsidiary and the depository institution. OTS' examination authority with respect to holding companies is subject to the same limitation.[18] Even with these limitations, both the Board and OTS have direct authority to examine a subsidiary – based solely on characteristics of the subsidiary – in order to assess the condition of an affiliated bank.

In contrast to the consolidated supervisory approaches of the Board and OTS, FDIC's supervisory authority is more limited and 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 in a holding company structure. Under section 10(b) of the FDI Act, FDIC, in the course of examining an institution, may 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."[19] 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 ownership of an insured institution or any of its affiliates.[20] According to FDIC officials, such an investigation would be triggered by concerns about the insured institution.

Consolidated supervisors have also instituted standards designed to ensure that the holding company serves as a "source of strength" for its insured depository institution subsidiaries. For example, the Board's regulations for bank holding companies include consolidated capital requirements that, among other things, can help protect against a bank's

[18]See 12 U.S.C. §§ 1467a(b)(4), 1831(a).

[19]See 12 U.S.C. 1820(b)(4)(A).

[20]See 12 U.S.C. § 1820(c).

exposure to risks associated with its membership in the holding company.[21]

Because FDIC does not supervise institutions affiliated with depository institutions on a consolidated basis, it has no direct authority to impose consolidated supervision requirements, such as capital levels 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 indicated that it 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.[22] 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.[23] 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.

Figure 3 compares some of the differences in explicit supervisory authority between FDIC and consolidated supervisors, specifically the Board and OTS. This figure 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 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

[21]12 C.F.R. Part 225, Appendices B & C.

[22]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).

[23]See 12 U.S.C. § 1813(u).

agency's authority to examine relationships between the institution and its affiliates and FDIC's 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.[24]

Figure 3: Comparison of Explicit Supervisory Authorities of the FDIC, Board, and OTS

Description of explicit supervisory authority	FDIC[a]	Board	OTS
Examine the relationships, including specific transactions, if any, between the insured institution and its parent or affiliates.	●[b]	●[b]	●[b]
Examine beyond specific transactions when necessary to disclose the nature and effect of relationship between the insured institution and the parent or affiliate.	●[b]	●[b]	●[b]
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.	○	●[b]	●[b]
Take enforcement actions against the parent of an insured institution.	◒[b,c]	●[b]	●[b]
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.	◒[b]	●[b]	●[b]
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.	○	●[b]	●[b]
Compel the parent and affiliates to provide various reports such as reports of operations, financial condition, and systems for monitoring risk.	◒[b,d]	●[b]	●[b]
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.	◒[d]	●	●
Compel the parent to divest of an affiliate posing a serious risk to the safety and soundness of the insured institution.	◒[e]	●	●

● Explicit authority

◒ Less extensive authority

○ No authority

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

[a]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.

[24]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.

[b]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.

[c]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.

[d]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.

[e]In addition to an enforcement action against the holding company of an ILC in certain circumstances (see note 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.

Further, in our report we described various areas where FDIC officials asserted that their supervisory approach could achieve similar results to those of consolidated supervision. However, we found that FDIC's authority in each of these areas was less extensive than consolidated supervision because these authorities can only be used under specific circumstances and 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. 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. Today, I will highlight two of these areas: the ability to examine certain ILC affiliates and the ability to terminate deposit insurance to illustrate how FDIC's authority is not equivalent to consolidated supervision of the holding company.

Table 2: The Extent of Selected FDIC Authorities

FDIC authority	Extent of authorities
Examine certain ILC affiliates.[a]	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 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 • the institution, its directors or trustees have engaged in unsafe or unsound practices; • the institution is in an unsafe or unsound condition; or • the institution, its directors or trustees have violated an applicable legal requirement, condition of insurance, or written agreement between the institution and FDIC.
Obtain written agreements from the acquiring entity in connection with a proceeding to acquire an ILC.[b]	Could be used if grounds for disapproval exist with respect to the acquirer.
Take enforcement actions against ILC affiliates.[c]	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.

[a]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.

[b]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 Change In Bank Control Act 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.

[c]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 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.

We agree that 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 information, but the use of these powers appears to be limited to examinations or investigations relating to the insured depository institution.[25] 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.[26] 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

[25] See 12 U.S.C. § 1820(c).

[26] See, for example, the focus of bank holding company examinations as prescribed in the BHC Act. 12 U.S.C. § 1844(c)(2).

is more able to detect the exposure.[27] FDIC's authority does not permit it to examine an affiliate based solely on its size, condition, or activities. While the most serious risk to an ILC would come from holding companies or affiliates that have a relationship with the ILC, the possibility that risks could come from affiliates with no relationship with the ILC should not 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. 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.[28] 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.[29] 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

[27]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.

[28]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).

[29]See 12 U.S.C. § 1818(a)(3),(5).

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 and terminated deposit insurance in 21 of these cases. In 94 of these 115 instances, corrective actions were taken, and the deposit insurance was not terminated.

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.

FDIC Actions May Help Mitigate Potential Risks

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.

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 7 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 no experience using its supervisory approach to mitigate potential losses from troubled ILCs that would qualify for supervision under its Large Bank program.[30]

FDIC's supervisory model and authority over BHC Act-exempt ILC holding companies and affiliates has emerged during a time when the banking industry has experienced relatively good times. Former FDIC Chairman Donald Powell 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.

[30]FDIC's large bank program provides an on-site presence at depository institutions with total assets greater than $10 billion or because of their size, complexity, and risk profile.

During the past 8 years, only 35 financial institutions protected by the Fund have failed, and FDIC has reported that insured institutions' earnings for 2004 set a new record for the fifth consecutive year and that the industry's equity capital ratio is at its highest level since 1938.[31] 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 and the test of supervision is its effectiveness during periods of stress. We have long advocated comprehensive regulation of financial services holding companies on both a functional and consolidated basis in order to assess how risks in other components of the holding company may affect the insured bank. We have stated that capital standards for both insured banks and their holding companies should adequately reflect all major risks. 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.

[31]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.

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

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.[32] Because of a provision in the ILC exception in the BHC Act, 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. As of March 31, 2006, 10 ILCs with total assets of about $ 3.6 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 March 31, 2006, approximately 15 of the 61 active ILCs were owned or affiliated with commercial entities, representing about $13.2 billion, (about 8.5 percent) and $8.2 billion (about 9.7 percent) of total ILC industry assets and estimated insured deposits, respectively.[33] In addition, there are a number

[32]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).

[33]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 8.5 percent of industry assets and 9.7 percent of industry estimated insured deposits.

of pending applications for deposit insurance with FDIC involving commercial firms, including one of the largest retail firms.

Regulators and practitioners with whom we spoke with also noted, however, that several other major industrial nations do allow a greater mixing of banking and commerce than does the United States. For example, in Europe 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 also 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 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.

Mixing Banking and Commerce Presents Both Potential Risks and Benefits

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. We have previously reported that the potential risks that may result from greater mixing of banking and commerce[34] 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.

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

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 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 of extending the safety net, and any associated subsidy, may be transferred to commercial entities. This risk, however, may be mitigated by statutory and regulatory safeguards between the bank and their commercial affiliates such as requirements for arms-length transactions and restrictions on the size of affiliate transactions under section 23A and 23B of the Federal Reserve Act. 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. 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 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 envision 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. 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. Enhanced product and geographic diversification could also reduce risk to the combined entity.

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. 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.

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 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.

Concluding Remarks

As we stated in our 2005 report, ILCs have significantly evolved from the small, limited purpose institutions that existed in the early 1900s. 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. While 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 insurance fund against ILC-related risks. However, FDIC's supervisory approach over ILC holding companies and affiliates has not been tested by a large ILC parent during periods of economic stress. Moreover, we are concerned that insured institutions posing similar risks to the Deposit Insurance Fund are not being overseen by bank supervisors that possess similar powers. Because of these differences in supervision, we 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. 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.

In addition, 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. Nevertheless, the potential risks from combining banking and commercial operations remain. These include 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 power exercised by large conglomerate enterprises. In addition, we find it unusual that this limited exemption for ILCs would be the primary means for expanding the mixing of banking and commerce than afforded to the holding companies of other financial institutions. Because it has been a long time since Congress has focused on the potential advantages and disadvantages of mixing banking and commerce and given the rapid

growth of ILC assets and a potential for increased attractiveness of the ILC charter, we concluded in our 2005 report that 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.

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions you or other Members may have at the appropriate time.

GAO Contacts and Staff Acknowledgments

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