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Statement of

Scott M. Polakoff, Senior Deputy Director
Office of Thrift Supervision

concerning

Industrial Loan Companies

before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

October 4, 2007

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I. Introduction

Good morning, Mr. Chairman, Ranking Member Shelby, 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). I want to commend you, Mr. Chairman, for holding this hearing. I also want to recognize the efforts of Senators Johnson and Bennett on their past and continuing work on ILC issues, as well as the efforts of Senators Brown, Johnson and Allard on recent ILC legislation.

Today, I will highlight for you 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. The OTS currently supervises entities that control over half of ILC industry assets. As of June 30, 2007, there were eight ILCs within OTS-regulated SLHC structures. These eight SLHCs, over which we are the primary federal regulator, include some of the most recognized names in the industry:

- Merrill Lynch & Co.;
- Morgan Stanley;
- American Express Company;
- USAA (United Services Automobile Association);
- Lehman Brothers Holdings, Inc.;
- General Electric Company;
- Beal Financial Corporation; and
- General Motors Corporation.

In other words, the OTS is the primary federal regulator for these SLHCs, whose subsidiary ILCs had aggregate assets of \$124 billion or over 55 percent of all ILC assets. In fact, four of the ten largest ILCs are owned or controlled by OTS-regulated SLHC structures. These four ILCs hold aggregate assets of \$118 billion, accounting for roughly 59 percent of the assets of the ten largest ILCs.¹ And of the top 15 ILCs,² the OTS

1. The ten largest ILCs held assets of almost \$201 billion, accounting for approximately 89 percent of aggregate ILC industry assets.

regulates SLHCs that own or control seven. These seven institutions hold assets of \$125 billion, representing 59 percent of the assets of the 15 largest ILCs. The OTS is an active holding company supervisor of all eight SLHCs that currently own an ILC.

ILC legislation raises a number of important 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. This includes the continuing role of existing holding company regulators, including the OTS, that oversee and supervise companies that currently own and control ILC industry assets. We believe it is important that any legislation include a 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. This is consistent with the objectives of functional regulation and consolidated regulatory oversight that are important aspects of recent banking legislation.

Understanding the potential exposure of the federal safety net to a company that owns or controls an ILC requires understanding and supervising the interrelationships within the structure and how the ILC is integrated. An effective holding company regulator must oversee the parent holding company of an ILC or other insured depository institution with a keen focus on any affiliate risks, including risks from commercial activities that could impact the insured financial institution. At the OTS, we currently regulate a number of commercial firms that own thrift institutions, and we have a sound and proven oversight program that addresses potential risks arising from commercial activities. In addition to several of the companies I have already highlighted, the commercial entities that we supervise include:

- Temple Inland, Inc. (manufacturing);
- Archer-Daniels-Midland Company (agribusiness);
- John Deere Capital Corporation (manufacturing);
- Nordstrom, Inc. (retail trade);
- Federated Department Stores, Inc. (retail trade);
- HEI Diversified, Inc. (utilities); and
- Hillenbrand Industries, Inc. (manufacturing).

Our SLHC oversight program is supported by our existing authority under the Home Owners' Loan Act (HOLA) that bars loans and extensions of credit by a savings institution to a commercial affiliate while also permitting the flow of credit to customers of a commercial affiliate for legitimate consumer lending activities.

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 on-site examinations, targeted reviews, and off-site monitoring. This combined approach permits the OTS to

2. The 15 largest ILCs held assets of \$213 billion, accounting for approximately 94 percent of aggregate ILC industry assets.

maintain an understanding of the enterprise-wide business activities and inherent risks, as well as the affiliations and the transactions of the enterprise.

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 primary federal regulator of holding companies that control over half of ILC industry assets.

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 supervisors as well as the FDIC under the Federal Deposit Insurance Act (FDIA). These entities are not considered "banks" under the BHCA.³ As a result, ILCs are currently not subject to holding company

3. 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."

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 active. As of June 2007, there were 59 institutions holding more than \$225 billion in aggregate assets. While the five largest institutions dominate the industry, holding \$158 billion or roughly 70 percent of aggregate industry assets, 18 of the 59 institutions have assets in excess of \$1 billion. As you are aware, interest in the ILC charter remains strong.

An issue that has generated some attention in the ILC debate is the role of a holding company regulator. Currently, there is a lack of clear statutory authority for a federal regulator of an ILC holding company that does not otherwise own a bank or thrift. It is important to address this issue while also recognizing the strength of the existing regulatory framework, which allows both the FRB and OTS to fulfill their statutory roles as holding company regulators.

III. OTS Authority and Supervision of SLHCs

The population of holding companies regulated by the OTS ranges 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 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 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 focus on how the company conducts business and manages risk throughout the enterprise. This approach 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. The program is designed to provide constructive and substantive feedback on these critical issues to boards of directors and management.

As noted above, OTS 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 (including SLHC affiliates and subsidiaries), 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.⁴ 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 other sectoral and functional regulators, including 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. Pursuant 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 is internationally recognized by foreign regulators, including the United Kingdom's Financial Services Authority (FSA) and France's Commission Bancaire, and has achieved equivalency status from the European Union for three firms – General Electric Company, AIG (American International Group), and Ameriprise Financial Group. We are also recognized by statute as one of two U.S. regulators (along with the FRB) authorized to make a determination as to whether a foreign bank entering the U.S. is subject to comprehensive consolidated supervision for purposes of coordinating consolidated oversight of its domestic banking activities. The OTS's status as a consolidated U.S. supervisor necessitates extensive contact with the domestic and international supervisory community for these and other internationally active complex firms supervised by the OTS.

In carrying out our statutory holding company authority, we conduct 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.

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

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

The OTS follows a risk-focused, top-down examination approach at all SLHCs. We analyze 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 risks to a SLHC, on a consolidated basis, and its subsidiary savings association.

OTS examination procedures are centered on an enterprise-wide assessment of the Capital, Organizational Structure, Risk Management,⁵ and Earnings/Liquidity of a 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. 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. We rely on the expertise and examinations of these functional regulators, rather than conducting our own examination of each material entity. If there is a material problem within an ILC that affects the holding company enterprise, we work closely with the functional regulator to minimize the impact on the enterprise and/or the OTS-regulated thrift.
- Cooperating extensively with the FDIC and the State of Utah on several information technology examinations of SLHCs with ILC subsidiaries. In these exams, each regulator appointed a central point of contact for each firm, with quarterly meetings to discuss examination strategy and planning.

5. Pursuant to guidance published for comment on April 9, 2007, the OTS is in the process of implementing a revised SLHC ratings and examination focus that substitutes Risk Management for the current Relationship component. This revision is consistent with the existing risk management focus of the OTS CORE ratings system for evaluating enterprise-wide risk assessment in OTS-supervised SLHCs.

- Requesting copies for review 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 our 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.

The OTS's consolidated holding company oversight program is a viable model for SLHCs with diverse and wide-ranging activities and operations. It is particularly effective in accommodating the various and sometimes competing interests 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.

IV. 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 Committee 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 more than half of ILC industry assets nationwide. In considering ILC legislation, we urge the Committee to preserve existing OTS authority and oversight of SLHCs that own or control ILCs. This will promote functional

regulation while also promoting consolidated regulatory oversight of these holding companies. Thank you.