REPORT

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U.S. CONGRESSIONAL HEARING ON INDUSTRIAL BANKS:

Is Consolidated Supervision of Parent Companies by the Federal Reserve Needed?

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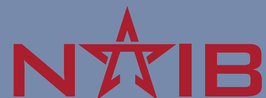

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AN IMPORTANT ISSUE RAISED

by some commentators is whether the lack of consolidated supervision of the parent companies of industrial banks (IBs)[1] by the Federal Reserve is serious enough to require new legislation, such as the Close the IB Loophole Act.[2] To gain more information regarding this issue, the U.S. House of Representatives Subcommittee on Consumer Protection and Financial Institutions held a hearing on "Banking Innovation or Regulatory Evasion? Exploring Trends in Financial Institution Charters" on April 15, 2021. This was an important hearing and therefore the views expressed by those testifying merit further examination before reaching any definitive conclusions regarding the need for consolidated supervision by the Federal Reserve of parent company ownership of IBs.

THE PURPOSE OF THIS REPORT

is to provide an examination of the views expressed at the hearing about the need for consolidated supervision of parent company ownership of IBs by the Federal Reserve. The intent of such an examination is not to argue the views are without merit but instead to examine whether those invited to testify have sufficiently documented that a serious enough problem has been identified and supported with meaningful evidence that corrective congressional legislative action is required.[3]

Views Expressed at the Congressional Hearing

At the hearing, a single-panel, consisting of five witnesses, was invited to testify : (1) Raul Carrillo of Yale Law School, (2) Erik Gerding of University of Colorado Law School, (3) Kristin Johnson of Emory University School of Law, (4) Carlos Pacheco on behalf of National Association of Federally-Insured Credit Unions, and (5) Brian Brooks, former acting Comptroller of the Currency.

We focus on the views of the witnesses regarding consolidated supervision of parent company ownership of IBs. The reason is that, although there may be multiple concerns expressed about IBs, as Erik Gerding states, "[m]ost basically, IBs are subject to inadequate supervision." He adds that "IBs are subject to FDIC supervision but not consolidated supervision (italics in original) by the Federal Reserve as are bank holding companies." Finally, he states: [t]he difference between supervision of the entity and consolidated supervision is crucial." Carlos Pacheco agrees when he states "[a]n IB charter can offer certain nonbank parent companies the opportunity to skirt registration as a bank holding company and avoid consolidated supervision by the Federal Reserve."

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Also in apparent agreement is Raul Carrillo, who states "... any companies acting as banks – regardless of the financial or non-financial nature of their parent companies – should be regulated as banks, under consolidated supervision." And, according to Kristin Johnson, "... the BHCA explicitly excludes IBs from the definition of a bank, thus excluding their holding companies from consolidated Fed supervision...." She adds that [w]eakness in the (unrestricted, unsupervised) IB parent could threaten the safety and soundness of the IB."[4]

OF THE FIVE WITNESSES, ONLY BRIAN BROOKS DOES NOT EXPRESS ANY CONCERNS ABOUT PARENT COMPANIES OF IBS NOT BEING SUBJECTED TO CONSOLIDATED SUPERVISION BY THE FEDERAL RESERVE.

Of the five witnesses, only Brian Brooks does not express any concerns about parent companies of IBs not being subjected to consolidated supervision by the Federal Reserve. Indeed, the only comment he makes about IBs is that "... many important regulatory innovations have arisen in state laboratories of experimentation, ... [including] ... industrial loan companies which have played an important role in specialty financial services for more than a century ...." His views are, therefore, not addressed in the report.

II Do the Views Provide Evidence Supporting Consolidated Supervision?

The views expressed at the hearing were quite fervent in arguing that a potential problem exists due to the lack of consolidated supervision of IBs and their parent companies by the Federal Reserve. It is, therefore, important to examine the evidence that is presented to support such strongly held views. We discuss the views of each of the four witnesses in turn.

A. Statements by Carlos Pacheco

(1) "... the FDIC's chartering and approval of deposit insurance for a new wave of Industrial Loan Companies (IBs) also present[s] problems."

(2) "Chartering additional IBs ... could ... weaken the safety and soundness of the wider financial system."

(3) "... the IB charter frustrates a core principle of prudential regulation: that a bank's parent company should serve as a transparent source of strength rather than an opaque source of risk."

(4) "Although the FDIC has attempted to patch up some of this risk with new regulation, the agency's December 2020 rule for IB parent companies is not a substitute for BHCA supervision...."

SUCH WORDS AS "COULD" AND "FRUSTRATES" AS WELL AS PHRASES LIKE "TRANSPARENT SOURCE OF STRENGTH" AND "OPAQUE SOURCE OF RISK" ARE NOT SUBSTITUTES FOR MEANINGFUL EVIDENCE.

A concern with these statements is that they are quite vague and, more importantly, no evidence is presented to support them. Such words as "could" and "frustrates" as well as phrases like "transparent source of strength" and "opaque source of risk" are not substitutes for meaningful evidence. Apart from these words and phrases, no meaningful evidence is presented that supports the view that FDIC and state supervision is not an appropriate substitute for Federal Reserve supervision. Also, contrary to his views, Mehrsa Baradaran (2010) states "[c]ommercial entities do not pose a greater risk than financial parents. Instead of increasing systemic risk, I argue that the commercial partnership arrangements of IBs reduce risks within banks and the system as a whole."

B. Statements by Raul Carrillo

(1) "As a general matter, any companies acting as banks — regardless of the financial or nonfinancial nature of their parent companies — should be regulated as banks, under consolidated supervision. Companies acting as BHCs should be regulated as BHCs."

(2) "It is time to permanently end the IB exemption: I thus support the "Close the IB Loophole" Act (C. Garcia), which would eliminate an exemption to the Bank Holding Company Act that permits IBs and their corporate owners."

> **NO REFERENCE IS MADE TO ANY OTHER STUDY, OR STUDIES, THAT SUPPORT THE VIEWS EXPRESSED. NOR ARE WEAKNESSES IN ANY STUDIES EXPRESSING CONTRARY VIEWS IDENTIFIED.**

The issue here is that no supporting evidence is provided for these opinions, beyond a single reference to a study by a professor of law at George Washington University Law School. No reference is made to any other study, or studies, that support the views expressed. [5] Nor are weaknesses in any studies expressing contrary views identified. More generally, in the 25-page statement, only one page is devoted to industrial loan companies.

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C. Statements by Kristin Johnson

(1) "Weakness in the (unrestricted, unsupervised) IB parent could threaten the safety and soundness of the IB. A common example is that of GMAC, which was GM's IB. GMAC required a $17 billion bailout and had to convert into a bank holding company."

(2) "While Dodd-Frank now requires IB parents to serve as a source of strength to the IBs they control, it is unlikely that a failing GM could have served as a source of strength to GMAC."

The statement that weakness in an IB parent could threaten the safety and soundness of its IB is simply an opinion. The only support for the opinion is the example of GMAC's difficulties during a stressful period, which required a $17 billion bailout. However, GMAC's subsidiary IB did not receive a bailout or fail. Also, no mention is made of the many bank holding companies that required bailouts. Moreover, according to Mehrsa Baradaran (2010), "[i]n effect, the crisis [of 2008] showed that a better source of strength for a bank is an entity whose liquidity is not dependent on the same infected financial system,

> **GMAC'S SUBSIDIARY IB DID NOT RECEIVE A BAILOUT OR FAIL. ALSO, NO MENTION IS MADE OF THE MANY BANK HOLDING COMPANIES THAT REQUIRED BAILOUTS.**

rather than a financial holding company whose instability is directly correlated with the instability of the bank." Furthermore, evidence is needed if one wishes to extrapolate from the experience of one IB parent commercial company as a source of strength to its subsidiary IB to projecting what will happen in the case of all future parent companies if called upon to be a source of strength to subsidiary IBs. Lastly, it should also be noted that only three pages of the 31-page statement are devoted to IBs.

D. Statements by Erik Gerding

(1) *"The 2020 FDIC reopening of deposit insurance to industrial loan companies ("IBs") threatens to:*

- *create risks to financial stability;*
- *distort competition in commercial markets;*
- *distort competition in banking markets and promote greater risk-taking;*
- *generate conflicts of interest in lending; and*
- *compromise consumer protections.*

The FDIC's ability to map and respond to these risks is limited by the fact that IBs and the conglomerates that own them are not subject to consolidated supervision."

(2) *"... [T]he IB exemption to the Bank Holding Company Act:*

- *Poses threats to financial stability;*
- *Creates an uneven playing field among commercial firms;*
- *Creates potential conflicts of interest in lending;*
- *Distorts banking markets; and*
- *Creates potential for abuses of consumers.*

Regulators cannot adequately detect or counter these threats because IBs and the conglomerates that own them are not subject to consolidated supervision."

(3) "... [T]he Federal Reserve cannot exercise consolidated supervision over IBs...." This means "...regulatory and supervisory duties *fall primarily on the FDIC and the state regulator that charters an IB."*

(4) *"In the global financial crisis, many parent companies did not serve as "sources of strength" for the IBs that they owned. To the contrary, many prominent nonbank financial firms that owned IBs failed*

or required substantial government assistance to remain afloat."

(5) *"The transformation of IBs into complex financial institutions and the growth in the size and number of IBs raises multiple concerns about the nature of the IB exemption."*

(6) Based on a chart that *"... summarizes the crisis fate of six prominent corporate owners of IBs"* ... *"... parents and affiliates of several prominent IBs did not serve as sources of strength during the financial crisis of 2007 and 2008."*

> **THE FDIC APPROVED ON DECEMBER 15, 2020, A FINAL RULE THAT CLARIFIES HOW IT INTENDS TO TREAT APPLICATIONS TO INSURE IBs OR TO MERGE WITH OR ACQUIRE CONTROL OF AN IB.**

Statements (1) and (2) by Erik Gerding indicate the potential threats he considers IBs pose and may materialize due to a lack of consolidated supervision by the Federal Reserve. However, statement (3) indicates in this case the regulatory and supervisory duties pertaining to IBs are the responsibility of the FDIC and the state regulators that charter IBs and therefore their obligation to curtail any potential threats.[6] He provides no evidence that the FDIC and state regulators are not capable of fulfilling their duties. Also, the FDIC approved on December 15, 2020, a final rule that clarifies how it intends to treat applications to insure IBs or to merge with or acquire control of an IB. According to Bob Jaworski (2021), "[t]The final rule requires a Covered Company[7] to enter into (1) one or more written agreements with both the FDIC and the subsidiary IB that contain commitments by the Covered Company to comply with specified reporting, record-keeping, and other requirements, and (2) such other written agreements, commitments or restrictions as the FDIC deems appropriate, (3) have less than 50 percent direct or indirect representation on each subsidiary IB Board, (4) maintain each subsidiary IB's capital and liquidity at levels the FDIC deems appropriate, and take such other actions as the FDIC deems appropriate to provide the subsidiary IB with a resource for additional capital and liquidity, and (5) execute a tax allocation agreement with each subsidiary IB to ensure that the IB is not prejudiced by the filing of a consolidated tax return." Even before the new rule, according to Mehrsa Baradaran (2010), "... the FDIC is armed with sufficient oversight and enforcement powers to prohibit certain ownership arrangements

> **THE FDIC IS ARMED WITH SUFFICIENT OVERSIGHT AND ENFORCEMENT POWERS TO PROHIBIT CERTAIN OWNERSHIP ARRANGEMENTS AND TO STOP HARMFUL ACTIVITIES OF IB COMMERCIAL PARENTS.**

and to stop harmful activities of IB commercial parents. If there is a potential for risk, the FDIC will prohibit bank ownership in the first place and, subsequently, take measures to reduce risk within a commercial-banking affiliation."

The bottom line is that no meaningful evidence is presented by Erik Gerding to indicate that with the new rule the FDIC, coupled with state supervision, cannot perform as well in dealing with IBs and their holding companies as would be the case with consolidated supervision by the Federal Reserve.

As regards statement (5) about the growth in the size and number of IBs, there were only 25 IBs in existence with $183 billion in total assets at year-end 2020, which represent 0.5 percent of all banks and 0.8 percent of all bank assets. The data hardly supports a view that the IB industry is a serious threat to financial stability. In the case of the statement (4), of the 25 firms that were the largest recipients of the Troubled Assets Relief Program (TARP) funds during the financial crisis, 12 were bank holding companies and they received $189 billion. At the same time, only one commercial holding company of an IB, GMAC, was included among the top 25 firms and it received $16 billion. This additional information indicates that consolidated supervision of bank holding companies of the Federal Reserve was not a panacea when it comes to preventing problems. It also indicates, as regards statement (6), that not all bank holding companies served as sources of strength to subsidiary banks.

THE BOTTOM LINE IS THAT NO MEANINGFUL EVIDENCE IS PRESENTED BY ERIK GERDING TO INDICATE THAT WITH THE NEW RULE THE FDIC, COUPLED WITH STATE SUPERVISION, CANNOT PERFORM AS WELL IN DEALING WITH IBS AND THEIR HOLDING COMPANIES AS WOULD BE THE CASE WITH CONSOLIDATED SUPERVISION BY THE FEDERAL RESERVE.

Since Erik Gerding mentions GE Capital Corporation in his statement, according to Mehrsa Baradaran (2010), "GE's IB and its parent [had] an income maintenance agreement wherein the GE parent funnels cash to its financing arm when it falls below a threshold. They injected $9.5 billion in the first quarter of 2009 and will continue to support the IB." Indeed, GE's IB did not fail but was voluntarily closed in April 2016. Also, Mehrsa Baradaran (2010) states "[m]ost IBs have similar income maintenance agreements, and several have been aided by their parent companies in the last two years during times of significant financial pressure."

Conclusion

In conclusion, the written statements by four witnesses submitted to the U.S. House of Representatives Subcommittee on Consumer Protection and Financial Institutions for its hearing on "Banking Innovation or Regulatory Evasion? Exploring Trends in Financial Institution Charters" that was held on April 15, 2021, have been examined. Based on an assessment of the views expressed, it has been found that there has been insufficient evidence presented to support new congressional legislation that would subject the parent companies of IBs to consolidated supervision by the Federal Reserve.

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Footnotes

Barth is in the Department of Finance at Auburn University and Sun is in the Department of Finance at Ryerson University. The authors received funding from the National Association of Industrial Bankers and the Utah Association of Financial Services to work on the report.

[1] Industrial loan companies (ILCs) and industrial banks (IBs) are terms frequently used interchangeably. We will use the term industrial banks throughout the report, even substituting the latter term for industrial loan companies in quotes.

[2] This bill would eliminate the exemption to the Bank Holding Company Act that permits IBs and their corporate owners to operate without consolidated supervision by the Federal Reserve.

[3] In a separate report, "Source of Strength and Consolidated Supervision: A Comparative Assessment of Industrial Banks and Commercial Banks", we provide informative information showing that concerns about whether parent companies of IBs can serve as sources of strength and whether consolidated supervision by the Federal Reserve is required of the parent companies of IBs are unfounded.

[4] Despite her concerns, Kristin Johnson does state "[o]ver the last century, IBs have performed an important role in the financial services markets."

[5] See, for example, Mehrsa Baradaran (2010) and Barth and Sun (2020).

[6] Stakeholders of both IBs and their parent companies also govern the activities of such firms to curtail excessive risk-taking behavior. Also, there is the Financial Stability Oversight Council that is charged with identifying risks to the financial stability of the United States; promoting market discipline; and responding to emerging risks to the stability of the United States' financial system. Lastly, the Antitrust Division of the Department of Justice and Federal Trade Commission play a role in the oversight of companies.

[7] A Covered Company basically means any company that is not subject to consolidated supervision by the Federal Reserve and that, directly or indirectly, controls an IB.

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