

January 2012

BANK HOLDING COMPANY ACT

Characteristics and Regulation of Exempt Institutions and the Implications of Removing the Exemptions



G A O

Accountability * Integrity * Reliability

Why GAO Did This Study

The Bank Holding Company Act of 1956 (BHC Act) establishes the legal framework under which bank holding companies—that is, companies which own or control banks—operate and restricts the type of activities that these companies may conduct. The BHC Act excludes from these restrictions certain companies because the financial institutions they own are exempt from the BHC Act definition of “bank”. However, these exempt institutions are eligible for FDIC insurance raising questions about continuing to exempt their holding companies from BHC Act requirements.

The Dodd-Frank Wall Street Reform and Consumer Protection Act directs GAO to study the implications of removing the exemptions. This report examines (1) the number and general characteristics of certain institutions in the U.S. banking system that are exempt from the definition of bank in the BHC Act, (2) the federal regulatory system for exempt financial institutions, and (3) potential implications of subjecting the holding companies of exempt institutions to BHC Act requirements. GAO analyzed data and exams from exempt institutions and regulators, and examined regulators’ guidance and policies. GAO also interviewed regulators and officials from 31 exempt financial institutions.

We provided a draft of this report to the relevant agencies. Treasury provided written comments and we received technical comments from other agencies which we incorporated as appropriate.

View [GAO-12-160](#). For more information, contact A. Nicole Clowers 202-512-8678 or clowersa@gao.gov.

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What GAO Found

The 1,002 exempt financial institutions make up a small percentage of the assets of the overall banking system—about 7 percent—and include industrial loan corporations (ILC), limited-purpose credit card banks, municipal deposit banks, trust banks with insured deposits, and savings and loans (S&L). Although exempt from the BHC Act, S&L holding companies are regulated by the Federal Reserve System Board of Governors (Federal Reserve) under the Home Owners’ Loan Act as amended. Excluding S&Ls, the number of exempt institutions drops to 57 that comprise less than 1 percent of banking system assets and there is a 3-year moratorium on the approval of federal deposit insurance on select exempt institutions that ends in 2013. These institutions vary by size, activities, and risks. Larger institutions such as ILCs provide banking services similar to those of commercial banks and carry many of the same risks. Other exempt institutions are smaller, provide only a few services such as credit card loans and related services, and thus have lower risk profiles.

Federal regulation of the holding companies of exempt institutions and their affiliates varies. The Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC) oversee ILCs, credit card banks, and trust banks, and focus their supervision on the institutions, not the parent holding companies. They examine the institutions for safety and soundness and for potential conflicts of interest in transactions with affiliates and the holding company. In contrast, the Federal Reserve oversees bank and, more recently, S&L holding companies using consolidated supervision that allows examiners to look at all entities and affiliates in the structure. OCC officials and representatives of exempt institutions viewed the current oversight as sufficiently robust. FDIC officials indicated that supervision of the exempt institutions themselves was adequate, but noted that consolidated supervision authorities provide important safety and soundness safeguards. Officials from the Federal Reserve and Department of the Treasury (Treasury) stated that the exemptions should be removed, given that exempt institutions have access to FDIC insurance and the holding companies of most types of exempt institutions are not subject to consolidated supervision.

The implications of subjecting exempt institutions and their holding companies to the BHC Act vary. While many officials from the exempt institutions owned by commercial holding companies said that the institutions would be divested, data suggest that removing the exemptions would likely have a limited impact on the overall credit market given the overall market share of exempt institutions is small. Views varied on how removing the exemptions would improve safety and soundness and financial stability. Some officials from exempt institutions said that financial stability could be adversely affected by further concentrating market share. Federal Reserve officials noted that institutions that remain exempt are not subject to consolidated supervision but could grow large enough to pose significant risks to the financial system, an issue they plan to continue to watch.

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Abbreviations

| | |
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| BHC Act | Bank Holding Company Act of 1956 |
| Dodd-Frank Act | Dodd-Frank Wall Street Reform and Consumer Protection Act |
| GLBA | Gramm-Leach-Bliley Act |
| FDI Act | Federal Deposit Insurance Act |
| FDIC | Federal Deposit Insurance Corporation |
| Federal Reserve | Federal Reserve System Board of Governors |
| FSOC | Financial Stability Oversight Council |
| HHI | Herfindahl-Hirschman Index |
| HOLA | Home Owners' Loan Act |
| ILC | industrial loan corporation |
| OCC | Office of the Comptroller of the Currency |
| OTS | Office of Thrift Supervision |
| S&L | savings and loans |
| SEC | Securities and Exchange Commission |
| SOD | Summary of Deposits |
| Treasury | Department of the Treasury |

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United States Government Accountability Office
Washington, DC 20548

January 19, 2012

The Honorable Tim Johnson
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable Spencer Bachus
Chairman
The Honorable Barney Frank
Ranking Member
Committee on Financial Services
House of Representatives

More than 7,500 banks insured by the Federal Deposit Insurance Corporation (FDIC) were operating in 2011, most of them owned or controlled by bank holding companies regulated under the Bank Holding Company Act of 1956 (BHC Act).¹ The BHC Act establishes the legal framework under which bank holding companies operate and establishes their supervision, which puts bank holding companies and their banking and nonbanking interests under the authority of the Board of Governors of the Federal Reserve System (Federal Reserve). The BHC Act also limits the types of activities that bank holding companies may conduct, either directly or through nonbank subsidiaries. The restrictions, which are designed to maintain the general separation of banking and commerce in the United States, only allow bank holding companies to engage in banking activities; to own and manage banks; and to engage in those activities that the Federal Reserve has determined to be “closely related to banking,” such as extending credit and servicing loans and performing

¹Pub. L. No. 84-511, 70 Stat. 133 (1956). Bank holding companies are companies that own or control a bank. 12 U.S.C. § 1841(a)(1). The BHC Act defines a bank as any of the following: (1) an insured bank or (2) an institution that both (a) accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others and (b) is engaged in the business of making commercial loans. 12 U.S.C. § 1841(c)(1).

appraisals of real estate and tangible and intangible personal property, including securities.

For various reasons, the BHC Act exempts from regulation certain companies that own depository institutions; these subsidiaries are not defined as banks for purposes of the BHC Act and thus the companies that own them are not considered bank holding companies and are not required to comply with the BHC Act's restrictions. Only one type of these companies—savings and loan holding companies—is subject to regulation at the holding company level, as follows.

- *Industrial loan corporations.* Industrial loan corporations (ILC) are limited-service financial institutions that make loans and raise funds by selling certificates called “investment shares” and by accepting deposits. ILCs are distinguished from finance companies because ILCs accept deposits in addition to making consumer loans. ILCs also differ from commercial banks because most ILCs do not offer demand deposit (checking) accounts.²
- *Limited-purpose credit card banks.* Limited-purpose credit card banks are generally restricted to credit card lending, can maintain only one office that accepts deposits, cannot accept demand deposits or transaction accounts, do not accept savings or time deposits of less than \$100,000 (unless used as collateral for extensions of credit), and do not engage in the business of making commercial loans (other than small business loans).
- *Municipal deposit banks.* Municipal deposit banks are state-chartered institutions that are wholly owned by thrift institutions or savings banks and restrict themselves to acceptance of deposits from thrift

²An exempt ILC either must not engage in any activity it was not lawfully engaged in as of March 5, 1987, or must be organized under state law either extant or contemplated by the state legislature as of March 5, 1987, requiring ILCs to be FDIC insured and meet one of the following conditions: (1) not accept demand deposits, (2) have total assets of less than \$100 million, or (3) not have been acquired after August 10, 1987. 12 U.S.C. § 1841(c)(2)(H).

institutions or savings banks, deposits arising out of the corporate business of their owners, and deposits of public monies.³

- *Savings and loans or thrifts.* Savings and loans (S&L) or thrifts are institutions that traditionally accepted deposits to channel funds primarily into residential mortgages. More recently, these institutions' charters have been expanded to allow them to provide commercial loans and a broader range of consumer financial services.⁴ As discussed in detail later in this report, S&L holding companies are regulated by the Federal Reserve Board and are subject to restrictions on the activities they conduct.
- *Trust banks.* Trust banks are institutions that function solely in a fiduciary capacity. All or substantially all of the deposits of such institutions must be in trust funds. Trust banks must not permit insured deposits to be marketed through affiliates and may not accept demand deposits.⁵

While these financial institutions are not considered banks under the BHC Act, each can offer deposit insurance under the Federal Deposit Insurance

³The BHC Act does not exempt municipal deposit banks from the definition of "bank." Instead, companies that own or control municipal deposit banks are not defined as bank holding companies. 12 U.S.C. § 1841(a)(5)(E). For purposes of this report, however, municipal deposit banks are referred to as exempt institutions.

⁴The BHC Act defines exempt S&L associations as (1) any federal savings association or federal savings bank; (2) any building and loan association, savings and loan association, homestead association, or cooperative bank if such association or cooperative bank is a member of the Deposit Insurance Fund; or (3) any savings bank or cooperative bank that was previously deemed by the Director of the Office of Thrift Supervision to be a savings association under Section 10(l) of the Home Owners' Loan Act. 12 U.S.C. §§ 1841(c)(2)(B) 1841 (j). A residential mortgage is a document signed by a borrower when a home loan is made that gives the lender a right to take possession of the property if the borrower fails to pay off the loan.

⁵Trust banks may not obtain payment services or borrowing privileges from the Federal Reserve. For this study, we identified only those trust banks that fell under the BHC Act exemption, (12 U.S.C. § 1841(c)(2)(D)) and that accept insured deposits. Serving in a fiduciary capacity includes serving as trustee, executor, custodian, administrator, registrar of stocks and bonds, guardian of estates, or committee of estates and incompetents. The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 604(i), 124 Stat. 1376,1604 (2010), excluded companies that control limited-purpose trust savings associations from regulation as S&L holding companies.

Act (FDI Act).⁶ Establishing or acquiring an institution that is not defined as a bank under the BHC Act is the only avenue for commercial companies to own depository institutions that are eligible for deposit insurance. However, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which was enacted in 2010, included a 3-year moratorium on approving federal deposit insurance for ILCs, credit card banks, and trust banks that are directly or indirectly owned or controlled by a commercial firm.⁷ In June 2009, the Department of the Treasury (Treasury) submitted a financial regulatory reform plan to Congress that, among other things, proposed amending the BHC Act by eliminating these exemptions and defining these institutions as banks. Treasury proposed that all holding companies owning an insured depository institution be subject to the BHC Act restrictions and the Federal Reserve's supervision.

Section 603 of the Dodd-Frank Act required us to conduct a study on certain institutions that are exempt from the BHC Act definition of a "bank." This report examines (1) the number of these institutions in the U.S. banking system that are exempt from the definition of bank in the BHC Act and their general characteristics; (2) the federal regulatory system for the exempt financial institutions and participants' views on it; and (3) the potential implications of subjecting the parents of the exempt institutions to the BHC Act provisions relating to the types of activities in which such institutions may engage, the availability and allocation of credit, the stability of the financial system and the economy, and the safe and sound operations of such institutions.

To determine the number of certain types of financial institutions that are exempt from the definition of "bank" in the BHC Act and their general characteristics, we analyzed data from FDIC, the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) and SNL Financial relating to the number of exempt institutions, their geographic location, their asset size, and their parent

⁶Enacted in 1999, the Financial Services Modernization Act (the Gramm-Leach-Bliley Act), Pub. L. No. 106-102, 113 Stat. 1338 (1999), allowed the continued exemption of ILCs, credit card banks, municipal deposit banks, and trust banks.

⁷Section 603(a) of the Dodd-Frank Act, 12 U.S.C. § 1815 *note*. A "commercial firm" derives less than 15 percent of its annual gross revenues from activities that are financial in nature, as defined in section 4(k) of the BHC Act, or from ownership or control of depository institutions.

holding company.⁸ We also interviewed officials from the Federal Reserve, FDIC, and OCC to obtain their understanding of the exemptions listed in the BHC Act. To determine whether the exempt institutions were owned by commercial holding companies, we first collected information from the federal bank regulators on the parent companies and identified publicly available information on their various business activities.⁹ We then compared the financial activities listed in Section 4(k) of the BHC Act to the activities of the parent holding companies to determine the extent to which financial activities contributed to the companies' 2010 annual gross revenue. In accordance with the Dodd-Frank Act, if 15 percent or more of a company's revenue was financial, we classified it as noncommercial. Companies that derived less than 15 percent of their revenue from financial activities were classified as commercial. We assessed the reliability of the data we obtained from each of the sources listed and determined that they were reliable for these purposes.

To describe the federal regulatory system for the exempt financial institutions, we reviewed 18 examinations of exempt institutions with assets of \$1 billion or more that FDIC and OCC conducted in 2008 through 2011. We judgmentally selected examinations for review based on the institutions' asset size, choosing larger institutions because of the potential risks they posed. The examinations we reviewed included ILCs, and limited-purpose credit card banks. Our review of examinations did not include trust banks and municipal deposit banks because none had assets of more than \$1 billion. We reviewed documentation from FDIC, OCC, and the Federal Reserve about their supervisory practices, including information from both the Federal Reserve and OCC on how they planned to carry out their new responsibilities for S&Ls and their holding companies.¹⁰ We interviewed officials from FDIC, the Federal

⁸SNL Financial is a private database of financial data of banking, financial services, insurance and real estate.

⁹Under the Dodd Frank Act, we were not required to determine whether the S&L holding companies were commercial or noncommercial. Certain holding companies owning a single S&L are exempt from the activity restrictions applicable to other S&L holding companies.

¹⁰As of July 21, 2011, the Dodd-Frank Act abolished the Office of Thrift Supervision (OTS), which had regulated and supervised federally chartered S&Ls and all S&L holding companies; the Dodd-Frank Act transferred these responsibilities to OCC and the Federal Reserve, respectively.

Reserve, and OCC regarding the supervision of all BHC Act exempt institutions, as well as S&L and holding company supervision.

To determine the potential effect on the credit markets of subjecting the parents of exempt institutions to the requirements of the BHC Act, we analyzed data from the exempt institutions, FDIC, the Federal Reserve, OCC, the Office of Thrift Supervision (OTS), the Securities and Exchange Commission (SEC), and SNL Financial, including institutions' Consolidated Reports of Condition and Income (Call Reports) submitted to FDIC and Thrift Financial Reports submitted to OTS.¹¹ We estimated market shares for each type of exempt institution in various loan markets for 2010. We also estimated loan market concentration for 2010 using the Herfindahl-Hirschman Index, a measure that reflects both the number of firms in the market and each firm's market share. We assessed the reliability of the data we obtained from each of the sources listed above and determined that they were reliable for these purposes.

To analyze other potential implications of subjecting the companies that own the exempt institutions to regulation under the BHC Act, we judgmentally selected a number of exempt institutions to interview. We interviewed representatives from 31 exempt institutions (ILCs, limited-purpose credit card banks, municipal deposit banks, S&Ls, and trust banks) selected on the basis of size of the exempt institutions and the commercial status of holding company. We also interviewed representatives from the American Bankers Association and the Independent Community Bankers Association. In addition, we interviewed representatives from two ILC holding companies that recently became bank holding companies to obtain their views on bank holding company supervision from the perspective of a former ILC holding company. We also interviewed officials from the Federal Reserve, OCC, FDIC, and Treasury to obtain their views on removing the exemptions. See appendix I for more information on our scope and methodology.

¹¹The Consolidated Reports of Condition and Income (Call Reports) are a primary source of financial data used for the supervision and regulation of banks. They consist of a balance sheet, an income statement, and supporting schedules. The Report of Condition schedules provide details on assets, liabilities, and capital accounts. The Report of Income schedules provide details on income and expenses. Every national bank, state member bank, and insured state nonmember bank is required to file a consolidated Call Report normally as of the close of business on the last calendar day of each calendar quarter. The specific reporting requirements depend upon the size of the bank and whether it has any foreign offices.

We conducted this performance audit between October 2010 and January 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

The U.S. bank regulatory structure is composed of several agencies at both the federal and state levels. The specific regulatory structure for a depository institution is determined by the type of charter the institution chooses. Depository institution charter types include commercial banks; S&Ls and savings banks; ILCs, also known as industrial banks; and credit unions. These charters can be obtained at the state and federal level, except for ILC charters, which are chartered only at the state level. State regulators help regulate the institutions they charter, but every institution that offers federal deposit insurance has a primary federal regulator (see table 1).

Table 1: Primary Federal Banking Regulators and Their Basic Functions, as of January 2012

| Regulator | Basic function |
|-----------------|--|
| OCC | Charters and supervises national banks and federal S&Ls |
| Federal Reserve | Oversees state-chartered banks that opt to be members of the Federal Reserve System, bank holding companies, S&L holding companies and their nondepository institution subsidiaries, and any firm designated as systemically significant by the Financial Stability Oversight Council |
| FDIC | Oversees state-chartered banks that are not members of the Federal Reserve System, as well as state-chartered savings banks and S&Ls; insures the deposits of all banks and S&Ls that are approved for federal deposit insurance; and resolves all failed insured banks and S&Ls and certain nonbank financial companies |

Source: GAO summary of information from OCC, the Federal Reserve, and FDIC.

To achieve their safety and soundness goals, bank regulators establish capital requirements, conduct onsite examinations and off-site monitoring to assess a bank's financial condition, and monitor compliance with banking laws. Regulators also issue regulations, take enforcement actions, and close banks they determine to be insolvent.

Regulatory Framework for Holding Companies

The BHC Act, as amended, contains a comprehensive framework for the supervision of bank holding companies and their nonbank subsidiaries. Bank holding companies are companies that own or control a bank, as defined in the BHC Act. Generally, any company that acquires control of an insured bank or bank holding company is required to register with the Federal Reserve as a bank holding company. The BHC Act defines

“control” of an insured bank to include ownership or control of blocks of stock, the ability to elect a majority to the board of directors, or other management prerogative.¹² Regulation under the BHC Act entails, among other things, consolidated supervision of the holding company by the Federal Reserve and, as previously discussed, restricts the activities of the holding company and its affiliates to those that are closely related to banking or, for qualified financial holding companies, activities that are financial in nature. In 1999, the Gramm-Leach-Bliley Act (GLBA) provided that a bank holding company may elect to become a financial holding company that can engage in a broader range of activities that the Federal Reserve determines to be financial in nature or incidental to such financial activity.¹³ For example, financial holding companies can engage in securities underwriting and dealing, but would be prohibited, for example, from selling unrelated products.

The Home Owners’ Loan Act (HOLA), as amended sets forth the regulatory framework for S&L holding companies.¹⁴ S&Ls are often part of holding company structures. Like bank holding companies, S&L holding companies are subject to restrictions on the activities they conduct. HOLA permits S&L holding companies to conduct activities that the Federal Reserve Board has determined to be closely related to

¹²Any one of the following circumstances will trigger coverage under the BHC Act: (1) *stock ownership*—the company owns, controls, or has the power to vote 25 percent or more of any class of the voting securities of a bank or bank holding company (either directly or indirectly or acting through one or more other persons); (2) *ability to elect a board majority*—the company controls the election of a majority of the directors or trustees of a bank or bank holding company; or (3) *effective control of management*—the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of a bank or bank holding company. For purposes of any such proceeding, it is presumed that any company that directly or indirectly owns, controls, or has power to vote fewer than 5 percent of any class of voting securities of a specific bank or bank holding company does not have the requisite control. See 12 U.S.C. § 1841(a)(1),(2).

¹³12 U.S.C. § 1843(k)(1). The financial holding company can engage in activities that the Board determines (1) to be financial in nature or incidental to such financial activity, or (2) are complementary to a financial activity and does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. The bank holding company and its depository institution subsidiaries must be well-capitalized and well-managed. 12 U.S.C. § 1843(l)(1).

¹⁴Pub. L. No. 73-43, 48 Stat. 128 (1933), 12 U.S.C. § 1461 et. seq

banking and activities permissible for financial holding companies.¹⁵ With the abolishment of OTS, the Federal Reserve is now the regulator for these holding companies.¹⁶ The Dodd-Frank Act made significant changes to the regulatory framework for S&L holding companies. The Dodd-Frank Act amends HOLA and the BHC Act to create similar requirements for both bank holding companies and S&L holding companies. For example, the Dodd-Frank Act amended both the BHC Act and HOLA to provide that the Federal Reserve Board has authority to impose capital requirements on depository institution holding companies by regulation or order, including bank holding companies and S&L holding companies.

Before GLBA, commercial companies could own a single S&L without becoming subject to the activities restrictions that apply to S&L holding companies, and a number of commercial firms—such as General Electric; Macy’s, Inc.; and Nordstrom, Inc.—acquired S&Ls. While GLBA prohibited commercial activities for all S&L holding companies, it “grandfathered” the companies that already owned an S&L subsidiary—that is, it allowed these companies to keep the existing S&L and engage

¹⁵HOLA permits an S&L holding company to engage in activities closely related to banking, activities permitted for financial holding companies, and certain other activities. The Dodd-Frank Act also requires S&L holding companies (other than grandfathered unitary S&L holding companies) to comply with certain requirements before they may engage in activities permissible for financial holding companies that previously applied only to bank holding companies. In order to conduct activities permissible for financial holding companies, S&L holding companies and their depository institution subsidiaries must be well-capitalized and well-managed. 12 U.S.C. § 1467a(c)(2)(H). These restrictions on activities do not apply to grandfathered unitary thrift holding companies as explained in the following paragraphs.

¹⁶The Dodd-Frank Act eliminated OTS, which chartered and supervised federally chartered S&Ls and S&L holding companies. 12 U.S.C § 5413. Rulemaking authority previously vested in OTS was transferred to OCC for S&Ls and to the Federal Reserve for S&L holding companies and their subsidiaries, other than depository institutions. 12 U.S.C. § 5412. Supervision of state chartered S&Ls was transferred to FDIC. 12 U.S.C. § 5412(b)(2)(C). The transfer of these powers was completed on July 21, 2011, and OTS was officially dissolved 90 days later (Oct. 19, 2011). In September 2011, the Federal Reserve issued Regulation LL, an interim final rule, to govern S&L holding companies. See 76 Fed. Reg. 56,508. S&L holding companies must obtain prior approval from the Federal Reserve for the formation of holding companies, the acquisition of control of depository institutions, and the merger of holding companies.

in commercial activities.¹⁷ The Dodd-Frank Act generally does not restrict the activities of grandfathered unitary S&L holding companies, but it amends HOLA to authorize the Federal Reserve to determine whether to require grandfathered unitary S&L holding companies engaged in nonfinancial activities to form intermediate holding companies. A grandfathered unitary S&L holding company will be required to establish an intermediate holding company if the Federal Reserve determines that the establishment of the intermediate holding company is necessary to appropriately supervise activities determined to be financial activities or to ensure that supervision by the Federal Reserve does not extend to the grandfathered unitary S&L holding company's nonfinancial activities. The intermediate holding company would be subject to regulation as an S&L holding company and would be required to conduct all or a portion of the firm's financial activities. The grandfathered unitary S&L holding company would be required to serve as a source of strength—that is, to provide financial assistance in the event of financial distress—to its subsidiary intermediate holding company. The Federal Reserve can also require certain reports from and undertake limited examinations of grandfathered unitary S&L holding companies.

In addition, the Dodd-Frank Act requires the Federal Reserve to require all bank holding companies and S&L holding companies to serve as a source of strength to their subsidiary depository institutions. The Federal Reserve regulations governing S&L holding companies state that an S&L holding company “shall serve as a source of financial and managerial strength to its subsidiary savings associations.” The Dodd-Frank Act defines the term “source of strength” as the ability of a company that directly or indirectly owns or controls an insured depository institution to provide financial assistance in the event of financial distress of the insured institution. If an insured depository institution is not the subsidiary of a bank holding company or an S&L holding company, the appropriate federal regulator for the insured depository institution will require any company that directly or indirectly controls the insured depository institution to serve as a source of financial strength to the insured depository institution.

¹⁷ 12 U.S.C. § 1467a(c)(3); 12 U.S.C. § 1467a(c)(9). The subsidiary must meet the “qualified thrift lender” test and maintain a minimum percentage of its assets in qualified thrift investments. If the subsidiary fails the test, the holding company will become a bank holding company. 12 U.S.C. § 1467a(m)(3)(C).

The Dodd-Frank Act also made significant changes in the capital requirements applicable to certain bank holding companies and S&L holding companies. Depository institution holding companies will be subject to minimum leverage and risk-based capital requirements on a consolidated basis. These capital requirements must not be lower than the leverage and risk-based capital requirements applicable to insured depository institutions as in effect on July 21, 2010. In general, the new capital requirements will apply to S&L holding companies beginning July 21, 2015.

Consolidated Supervision

The Federal Reserve's bank holding company supervision manual explains that the holding company structure can adversely affect the financial condition of a bank subsidiary by exposing the bank to various types of risk, including market, operational, and reputational risks. For example, a holding company or an affiliate with poor risk management procedures may take excessive investment risks and fail. The failure of a holding company or affiliate can impair an insured institution's access to financial markets. Moreover, a poorly managed bank holding company can initiate adverse intercompany transactions with the insured depository institution or impose excessive dividends on it.¹⁸ Adverse intercompany transactions may include charging the insured depository institution above-market prices for products or services, such as information technology services, provided by an affiliate or requiring the insured institution to purchase poor quality loans at inflated prices from an affiliate, thus placing the insured institution at greater risk of loss. Market risk is the risk to a banking organization's financial condition resulting from adverse movements in market prices due to such factors as changing interest rates. Operational risk is the potential that inadequate information systems, operations problems, breaches in internal controls, or fraud will result in unexpected losses. From a practical standpoint, insured depository institutions may be susceptible to operational risk when they are dependent on or share in the products or services of a holding company or its subsidiaries, such as information technology services or credit card account servicing. If these entities ceased their operations, the insured institution could be adversely impacted. Reputational risk is the potential that negative publicity regarding an institution's or affiliate's business practices, whether true or not, could

¹⁸As discussed more fully later in this report, federal law restricts transactions between an insured depository institution and its bank holding company affiliates.

cause a decline in the customer base, costly litigation, or revenue reductions. Operational or reputational risk that impacts the holding company can also affect affiliates throughout the corporate structure.

The BHC Act has established a consolidated supervisory framework for assessing the risks to a depository institution that could arise because of its affiliation with other entities in a holding company structure. Consolidated supervision of a bank holding company includes the parent company and its subsidiaries and allows the regulator to understand the organization's structure, activities, resources, and risks and to address financial, managerial, operational, or other deficiencies before they pose a danger to the bank holding company's subsidiary depository institutions. According to Federal Reserve Board Supervisory Letter SR 08-9, the agency has established capital standards for bank holding companies, helping to ensure that they maintain adequate capital to support groupwide activities, do not become excessively leveraged, and are able to serve as a source of strength to their depository institution subsidiaries. The Federal Reserve may generally examine holding companies and their nonbank subsidiaries, subject to some limitations, to assess the nature of the operations and financial condition of the holding company and its subsidiaries, the financial and operational risks within the holding company that may pose a threat to the safety and soundness of any depository institution subsidiary, and the systems for monitoring and controlling such risks, among other things.

As the new regulator for S&L holding companies, the Federal Reserve has indicated that it intends, to the greatest extent possible taking into account any unique characteristics of S&L holding companies and the requirements of HOLA, to assess the condition, performance, and activities of S&L holding companies on a consolidated basis in a manner that is consistent with the Board's established risk-based approach regarding bank holding company supervision.

In contrast, FDIC and OCC do not have consolidated supervisory authority over the holding companies for the exempt banking institutions but do have full authority to apply to them the same federal regulatory safeguards that apply to all insured banks and S&Ls. For example, FDIC and OCC can impose conditions and examine agreements, dependencies, and transactions between exempted depository institutions and their holding companies (including affiliated entities) in order to better ensure the safety and soundness of those institutions. Furthermore, FDIC can terminate an exempted entity's deposit insurance, enter into agreements during the acquisition of an insured entity, and take

enforcement measures. In addition, FDIC possesses authority under Section 10 of the FDI Act to examine the affairs of any affiliate of any depository institution as may be necessary to disclose fully (1) the relationship between such depository institution and any such affiliate and (2) the effect of such relationship on the depository institution.

BHC Act Exemptions

Section 2 of the BHC Act exempts companies owning certain types of financial institutions from regulation under the BHC Act because the institutions they own are not defined as “banks” in the BHC Act. Companies owning these institutions are not considered bank holding companies; are not required to comply with the BHC Act’s restrictions on activities; and with one exception, they are not subject to the Federal Reserve’s oversight. The statutory exemptions from the definition of “bank” were established by the Competitive Equality Banking Act of 1987 (CEBA), which also expanded the definition of “bank” in the BHC Act to include all FDIC-insured institutions.¹⁹ The CEBA exemptions include ILCs, limited purpose credit card banks, trust banks and S&Ls.²⁰ One type of exempt institution, ILCs, began in the early 1900s as small, state-chartered loan companies that served the borrowing needs of industrial workers who were unable to obtain noncollateralized loans from commercial banks. The ILC industry experienced significant asset growth in the 2000s, and ILCs evolved from small, limited-purpose institutions to a diverse group of insured financial institutions with a variety of business models. S&Ls are exempt institutions but S&L holding companies were subject to holding company supervision by OTS and now the Federal Reserve. In addition, S&L holding companies are subject to restrictions on activities set out in HOLA. We also considered one type of institution

¹⁹Pub. L. No. 100-86, § 101, 101 Stat. 552, 554 (1987).

²⁰The exempt institutions that the Dodd-Frank Act required us to address are described at 12 U.S.C. §1841(c)(2)(F) for credit card banks; 12 U.S.C. §1841(c)(2)(H) for ILCs; 12 U.S.C. §1841(a)(5)(E) for municipal deposit banks; 12 U.S.C. §1841(c)(2)(B) for S&Ls; and 12 U.S.C. §1841(c)(2)(D) for trust banks.

that was exempted by the Bank Holding Company Act Amendments of 1970, municipal deposit banks.²¹

Table 2 identifies the federal regulators for the certain types of exempt institutions.

| Table 2: Certain BHC Act Exempt Institutions and Their Federal Regulators | |
|---|---|
| Exempt Institution | Federal regulator |
| ILC | <ul style="list-style-type: none">• FDIC |
| Limited-purpose credit card bank | <ul style="list-style-type: none">• Federally chartered: OCC• State chartered: FDIC |
| Municipal deposit bank | <ul style="list-style-type: none">• FDIC |
| Trust bank | <ul style="list-style-type: none">• Federally chartered: OCC• State chartered: FDIC |
| S&L | <ul style="list-style-type: none">• S&L holding companies: Federal Reserve• Federally chartered S&Ls: OCC• State chartered S&Ls: FDIC |

Sources: GAO summary of information from FDIC, the Federal Reserve, and OCC.

Exempt Financial Institutions Vary by Size, Ownership, Activities, and Risks

Financial institutions that are exempt from the BHC Act definition of bank make up a small percentage of the overall banking system—1,002 institutions (about 7 percent)—and include ILCs, limited-purpose credit card banks, municipal deposit banks, trust banks with insured deposits, and S&Ls. If S&Ls, which are different from the other types of exempt institutions in that they are regulated by the Federal Reserve at the holding company level, are excluded, the percentage drops to less than 1 percent,

²¹12 U.S.C. § 1841(a)(5)(E) exempts companies owning any state-chartered bank or trust company that is wholly owned by thrift institutions or savings banks and is restricted to accepting deposits from thrifts or savings banks; deposits from the business of the thrift or savings bank’s business; and deposits of public monies. 12 U.S.C. § 1841(a)(5)(F) exempts from bank holding company regulation trust companies and mutual savings banks that control one bank located in the same state that meets certain criteria. Both of these exemptions were enacted in the Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, § 101(a), 84 Stat. 1760 (1970). According to the Federal Reserve, the legislative history of this act indicates that the exemption in 12 U.S.C. § 1841(a)(5)(F) was intended to apply to Missouri trust companies and Rhode Island mutual savings banks that owned or controlled a bank, as authorized by state law, before 1971. According to Federal Reserve officials, supervisors in Rhode Island and Missouri have informed them that, as of December 2010, there were no trust companies or mutual savings banks operating under the exemption. See H.R. Rept. No. 91-1084, at 11 (1970).

or 57 institutions. Determining whether the holding companies that own exempt institutions are commercial is difficult, given the lack of a standard definition and limited publicly available data on exempt institutions. The risk profiles for exempt institutions vary, reflecting differences in the institutions' size, complexity, and level of banking and nonbanking activities.

Exempt Institutions Make Up about 7 Percent of the U.S. Banking System

The assets of institutions exempt from the definition of bank in the BHC Act that we reviewed account for about 7 percent of the total assets in the U.S. banking system.²² S&Ls account for almost 7 percent of all FDIC-insured institutions, as of June 30, 2011. The 57 institutions among the other types of exempt institutions as of 2011 held less than 1 percent in the assets of FDIC-insured banks.²³ The 57 non-S&L exempt institutions were ILCs (34), limited-purpose credit card banks (10), trust banks (3), and municipal deposit banks (10). These exempt institutions were generally small in terms of assets. For example, only 8 of the 57 exempt institutions had assets of more than \$5 billion, and more than half of them had assets of less than \$500 million. Appendix II contains additional information on these 57 exempt institutions, including their federal regulators and asset sizes.

Aside from S&Ls, the largest category of exempt institutions is ILCs, which have been declining in number and size in recent years. Since 2006, the number of ILCs has declined from 58 to 34, and the assets of these institutions have dropped from \$212.7 billion to \$102.4 billion. Federal regulators and industry representatives attributed these declines to several factors, but most frequently to the federal moratoriums on deposit insurance for new ILCs. In particular, FDIC imposed a moratorium on deposit insurance

²²For the purposes of this report, we define the U.S. banking system to be the collection of all FDIC-insured institutions.

²³The number and size (as measured by assets) of S&Ls have declined in recent years. In 2006, there were about 1,103 S&Ls with combined assets of \$1.6 trillion. As of June 30, 2011, there were about 945 S&Ls with combined assets of \$0.9 trillion. S&Ls owned by bank holding companies were not included in the number of S&Ls we identified in 2006 or 2011. An OCC official attributed this decline to statutory changes that removed the primary advantages of holding an S&L charter over commercial banks. Specifically, commercial banks can now branch across state lines, and S&Ls are now subject to the same preemption standards as national banks. Counts of ILCs, limited-purpose credit card banks, municipal deposit banks, and trust banks only include those that are not subsidiaries of bank holding companies.

for new ILCs in 2006, and no ILCs have been approved since then.²⁴ Also, during the 2007-2009 financial crisis, a number of the larger ILC holding companies applied and were approved to become bank holding companies, including American Express Company; Goldman Sachs Group, Inc.; Morgan Stanley; and GMAC Financial Services. Merrill Lynch & Co. also owned an ILC that became part of the Bank of America Corporation, a bank holding company, when it acquired Merrill Lynch in 2008. Subsequent to the FDIC moratoriums, the Dodd-Frank Act placed a 3-year moratorium on FDIC approval of deposit insurance applications received after November 23, 2009, for ILCs, credit card banks, and trust banks that were directly or indirectly owned or controlled by a commercial firm. In addition, the Dodd-Frank Act provides that until July 21, 2013, FDIC may not approve any change in control of an ILC, trust bank, or credit card bank that would place the institution under the control of a commercial firm.

The combined assets of limited-purpose credit card banks, trust banks, and municipal deposit banks totaled \$10.3 billion as of June 30, 2011. The assets of the 10 limited-purpose credit card banks, which issue only credit cards, totaled \$8.5 billion, and the assets of these limited-purpose credit card banks ranged from \$3 million to \$4.7 billion.²⁵ Many limited-purpose credit card banks sell their credit receivables to the parent company, so their assets are typically small. Four limited-purpose credit card banks issue what are called private-label cards, while three issue general-purpose credit cards and two offer both types.²⁶ The 10 municipal deposit banks' assets totaled \$1.5 billion, and the three trust banks' assets totaled about \$318 million, as of June 2011.

²⁴In July 2006, FDIC imposed a 6-month moratorium on approving any deposit insurance applications and change in control notices for ILCs. In January 2007, this moratorium was extended for a year with respect to those deposit insurance applications and change in control notices filed by nonfinancial companies. The moratorium expired in January 2008. Several large corporations had submitted applications to FDIC for deposit insurance prior to the—moratorium—such as Ford Motor Company; Wal-Mart Stores, Inc.; and the Home Depot, but they withdrew their applications before FDIC ruled on them.

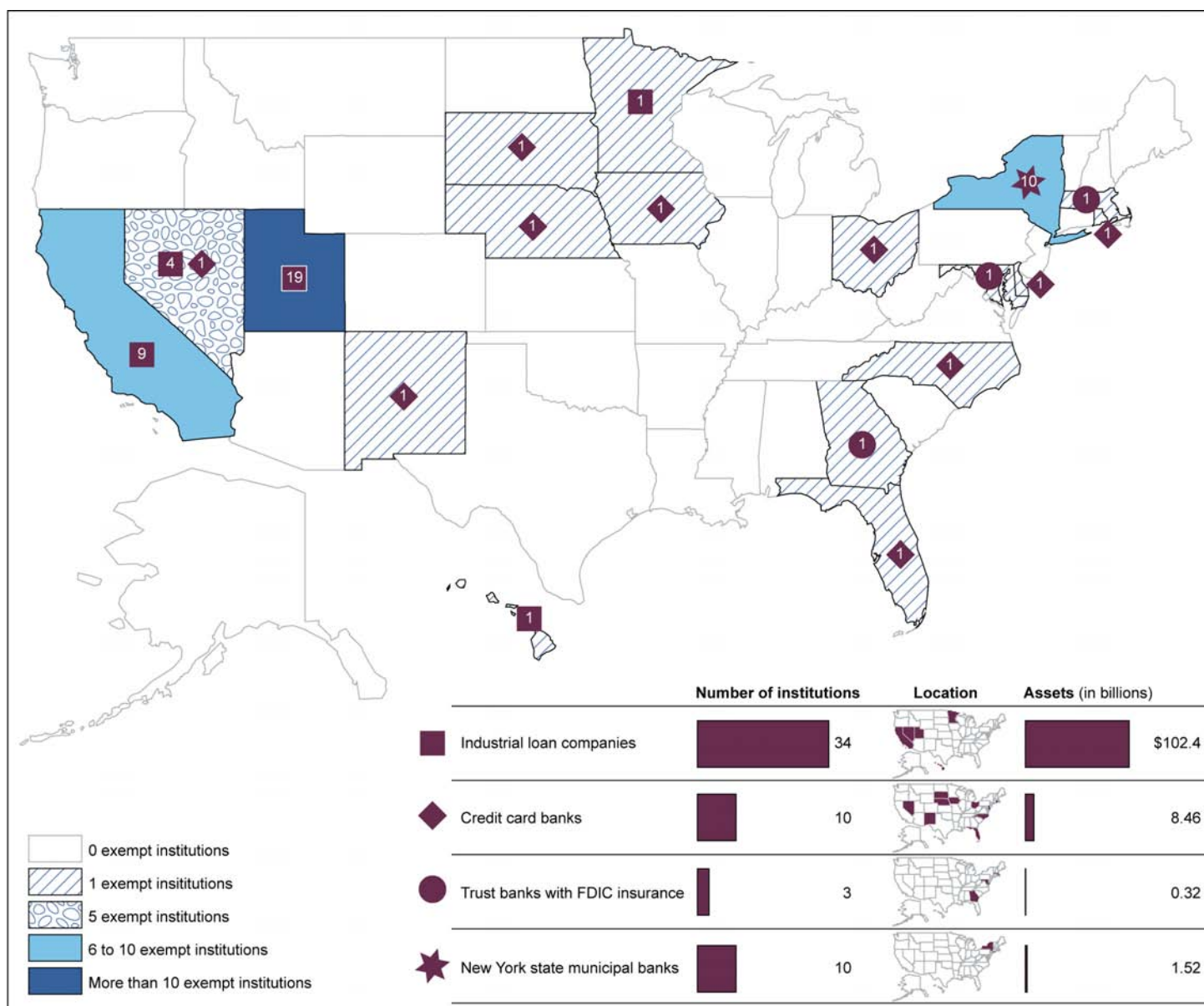
²⁵Credit card issuers are any person who issues a credit card or the agent of such person with respect to such card.

²⁶General-purpose or universal credit cards can be used at a variety of stores and businesses. Private-label credit cards are issued under an open-ended agreement and can be used to make purchases only at a single merchant or an affiliated group of merchants.

As shown in figure 1, ILCs, limited-purpose credit card banks, municipal deposit banks, and trust banks are geographically concentrated. For example, limited-purpose credit card banks are located in 10 states. ILCs are located in five states—California, Hawaii, Nevada, Minnesota, and Utah. All 10 municipal deposit banks are located in New York, and the 3 trust banks are located in Georgia, Maryland, and Massachusetts.²⁷ In contrast, as of June 30, 2011, 945 S&Ls (including both federally and state-chartered S&Ls) were in operation and of these approximately 426 are owned by S&L holding companies, concentrated primarily in New England, the Northeast, and the Midwest as of June 30, 2011.

²⁷ According to the Federal Reserve, municipal deposits banks are all located in the state of New York because under New York state law, savings banks cannot accept deposit from municipalities. The creation of a municipal deposit subsidiary bank allows the savings banks to accept these deposits. Although the municipal deposit banks have commercial bank charters, a company that owns or controls a municipal deposit bank is not a BHC.

Figure 1: Geographic Distribution of ILCs, Limited-Purpose Credit Card Banks, Trust Banks, and Municipal Deposit Banks, as of September 30, 2011



Source: FDIC, OCC, and the New York State Department of Financial Services (data); MapInfo (map).

Ownership Type of the Holding Companies That Own Exempt Financial Institutions Is Often Not Clear

Determining whether holding companies that own ILCs, limited-purpose credit card banks, municipal deposit banks, and trust banks are commercial or noncommercial is challenging, for several reasons. For example, the lack of publicly available data on the holding companies' revenue sources complicates efforts to determine the ownership type. Some holding companies that own exempt institutions are not public companies and thus are not required to submit filings that contain such information that would be publicly available. In addition, regulators do not make the distinction between commercial and noncommercial ownership. FDIC officials told us that they focused on the activities and risks of the exempt institutions and their holding companies regardless of type. The Dodd-Frank Act sets forth a definition of "commercial": companies are considered commercial if revenue from financial activities (as defined under Section 4(k) of the BHC Act) generates less than 15 percent of their annual gross revenue.²⁸ Using this definition, a number of companies that are generally considered commercial would be considered noncommercial because their revenue from financial activities is 15 percent or more. For example, using this definition, the General Electric Company is classified as noncommercial because its financial services business segment accounted for more than 31 percent of its 2010 annual gross revenue.

Working within these challenges and limitations, we were able to determine the status of the holding companies for 43 of the 57 ILCs, limited-purpose credit card banks, municipal deposit banks, and trust banks. Using the definition of commercial from the Dodd-Frank Act and publicly available financial data, we determined that 11 exempt institutions were owned by commercial companies and 32 by noncommercial companies (see table 3). The status of the holding companies of the remaining 14 institutions could not be determined because of the lack of sufficiently detailed, publicly available financial data about the companies or information from OCC or FDIC.²⁹

²⁸Annual gross revenue is the total income of a business for 1 year.

²⁹For this report, we are using the term "noncommercial" rather than "financial holding company" to avoid confusing these holding companies with financial holding companies that are bank holding companies that make an election to be treated as financial holding companies.

Table 3: Commercial Status of Holding Companies Owning ILCs, Limited-Purpose Credit Card Banks, Municipal Deposit Banks, and Trust Banks, as of December 31, 2010

| Type of exempt institutions | Owned by noncommercial companies ^a | Owned by commercial companies | Ownership undetermined |
|-----------------------------------|---|-------------------------------|------------------------|
| ILCs | 19 | 5 | 10 |
| Limited-purpose credit card banks | 1 | 6 | 3 |
| Municipal deposit banks | 10 | 0 | 0 |
| Trust banks | 2 | 0 | 1 |
| Total | 32 | 11 | 14 |

Sources: GAO analysis based on 2010 SEC filings, company 2010 annual reports, and OTS data.

^aNoncommercial holding companies are generally financial in nature.

According to information from OCC, one trust bank owned an affiliate as of May 7, 2011. However, under the Dodd-Frank Act definition of commercial, the affiliate is non-commercial.

Exempt Institutions' Risk Profiles Vary

The risk profiles for exempt institutions vary, reflecting differences in the institutions' size, complexity, and level of banking and nonbanking activities. While few of the exempt institutions are large depository institutions that pose significant systemic risk to the financial system, many engage in several types of banking and nonbanking activities that carry a variety of risks. These risks exist at the depository institution and holding company levels.

- *ILCs.* The Federal Reserve and Treasury view these institutions as full-service commercial banks and therefore view the risks they pose as similar to those of commercial banks, including credit risk. The FDIC concurs in this view and noted that many exempt institutions primarily accept brokered deposits, considered to be riskier than

demand deposits because of concerns about liquidity risks.³⁰ ILCs can provide a wide range of banking services and are able to make loans (including credit card loans) and investments, like commercial banks.

- *Limited-purpose credit card banks.* These exempt institutions are generally restricted to credit card lending activities and are not permitted to conduct many banking activities, such as mortgage or commercial lending.³¹ They are not permitted to accept demand deposits. The most dominant risks for these banks are compliance, liquidity, reputational, and to some extent credit risk.
- *Municipal deposit banks and trust banks.* These exempt institutions' banking activities are limited. The sole purpose of municipal deposit banks is to accept municipal deposits, and these banks do not make commercial or consumer loans. Similarly, the three trust banks that are exempt from the BHC Act function only in a fiduciary capacity and do not pose the same types of financial risks as commercial banks. Their risk profile is based on fiduciary responsibility and litigation risk.
- *S&Ls.* These exempt institutions offer a range of banking services that are similar to those provided by commercial banks, including offering a variety of banking products, accepting demand deposits and making commercial, real estate, and residential mortgage loans. Because S&Ls are similar to commercial banks, they are exposed to credit,

³⁰Brokered deposits are deposits acquired through a deposit broker. "Deposit broker" means (1) any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions, or any person in the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties, and (2) an agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan. A demand deposit means that the depositor has a right to withdraw at any time without prior notice to the depository institution. Demand deposits are commonly offered in the form of checking accounts.

³¹A bank holding company may own an insured bank that engages exclusively or predominantly in credit card activities. Credit card banks owned by bank holding companies may legally offer additional commercial banking services unless prohibited by the articles of association. These banks are "banks" under the BHC Act, and a company that owns one is subject to the BHC Act. The Dodd-Frank Act permits exempt credit card banks to provide small business loans.

liquidity, operational, reputational, and compliance risks. However, as discussed, unlike the owners of other exempt institutions, S&L holding companies are subject to supervision and regulation at the holding company level, by the Federal Reserve.

In addition to their banking activities, commercial ownership of exempt institutions could pose additional risks. Federal Reserve, FDIC and Treasury officials each acknowledged the risk that a commercial holding company may seek to operate an exempt financial institution for the holding company's own benefit. For example, ILCs and limited-purpose credit card banks could be directed to engage in transactions that benefited the holding company's affiliates but were detrimental to the financial institutions' safety and soundness. To address adverse transactions between an insured institution and its affiliates, Congress restricted the ability of insured depository institutions, including exempt institutions, to enter into transactions with affiliates.³² Insured institutions are subject to both qualitative and quantitative limits on transactions with affiliates. For example, a bank may not engage in a transaction with an affiliate if the aggregate amount of the bank's covered transactions with all affiliates would exceed 20 percent of the bank's capital stock and surplus.³³ In addition, an institution generally cannot purchase low-quality assets from an affiliate. Congress established collateral requirements for credit transactions provided to an affiliate, generally requiring that a credit transaction be secured by collateral having market value of at least 100 percent of the transaction. All covered transactions between depository institutions and their affiliates must be on terms and conditions that are consistent with safe and sound banking practices.³⁴ Additionally, covered transactions between institutions and their affiliates must occur on market terms, which must be at least as favorable to the institution as those prevailing at the time for comparable transactions with unaffiliated companies.³⁵

³²A covered transaction includes a loan or extension of credit to an affiliate; a purchase of, or an investment in the securities issued by the affiliate, guarantees on behalf of an affiliate, and certain other transactions that expose the insured institution to the affiliate's credit or investment risk. An institution's affiliates include any company that controls or is controlled by the institution, and any company under common control with the institution. 12 U.S.C. § 371c(b)(1).

³³12 U.S.C. § 371c(a)(1).

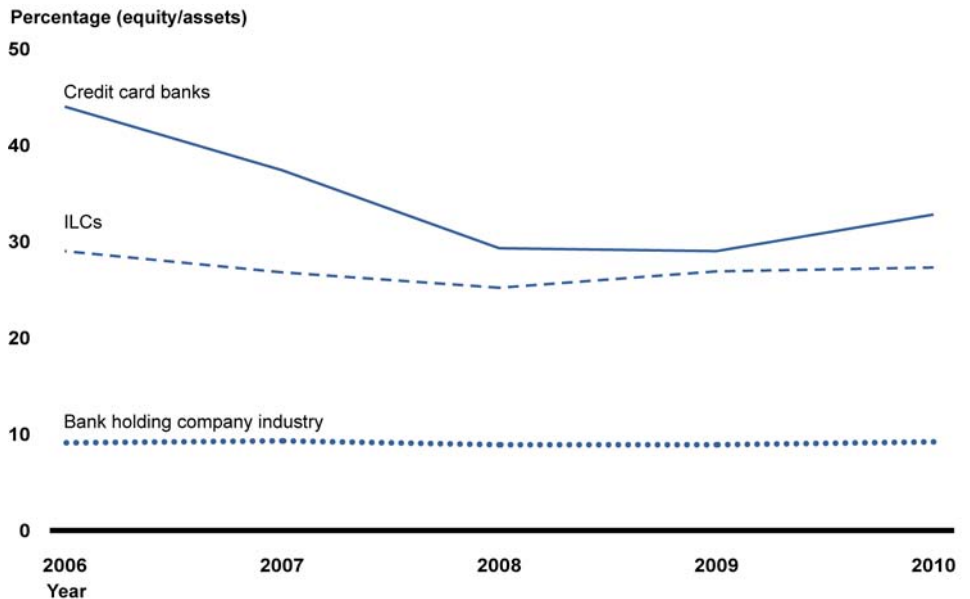
³⁴12 U.S.C. § 371c(a)(4).

³⁵12 U.S.C. § 371c-1(a)(1).

While the regulators view the commercial ownership of exempt institutions as posing potential risks to the financial institution, representatives from exempt institutions countered that such ownership could be a source of strength. In particular, representatives of the 14 ILCs and 3 limited-purpose credit card banks we interviewed said that their holding companies currently could serve as a source of strength to their depository institutions. To assess whether these holding companies could be a source of strength to the financial institution, we analyzed the capitalization of holding companies for ILCs and credit card banks.³⁶ On average, the holding companies of ILCs and credit card banks we analyzed had higher ratios of equity-to-total assets over the 5-year period than bank holding companies (see fig. 2). The higher ratio shows that these holding companies had a higher, stronger cushion against losses that might occur. The average equity-to-total assets ratios for limited-purpose credit card banks remained above 20 percent over the period. In comparison, the average equity-to-total assets ratio of bank holding companies with total assets of more than \$500 million that were required to file financial data with the Federal Reserve remained below 10 percent during the same period.

³⁶For bank holding companies, we calculated the average of the ratio of equity capital to total assets for 2006-2010 using the data from bank holding companies' Form FR Y-9C filings. For parent holding companies of industrial loan corporations and limited purpose credit card banks that are not bank holding companies, we calculated the average of the ratio of equity to assets for 2006-2010 using balance sheet data from SNL Financial or from companies' annual report or 10-K filings.

Figure 2: Average Equity-To-Total Assets Ratios for Holding Companies of ILCs and Limited-Purpose Credit Card Banks Compared with Those of Bank Holding Companies, 2006-2010



Source: GAO analysis of SEC filings.

Note: We examined the equity positions of the ILCs and the limited-purpose credit card banks because they were more likely to be owned by commercial firms compared to the other exempt institutions. We analyzed the equity-to-total ratios assets for 44 institutions.

Federal Reserve acknowledged that commercial holding companies may be able to act as a source of strength for exempt institutions. However, they expressed three concerns. First, Federal Reserve officials noted that no federal regulator was assigned to look at the health of the entire holding company for an exempt institution, other than for S&Ls, creating a potential regulatory “blind spot.” The officials explained that a regulator should have the authority to look at the entire organization and not at what affects only the depository institutions. Second, holding companies of ILCs are not held to the same risk management and capital standards as bank holding companies, according to the officials. For example, through consolidated supervision, the Federal Reserve assesses a bank holding company’s risk management functions and its impact on the depository institution. Third, regulators cannot take enforcement actions to compel nonbank holding companies to serve as a source of strength

for the exempt institution.³⁷ Prior to the Dodd-Frank Act, FDIC and OCC could ask holding companies to inject capital into exempt depository institutions and to enter into agreements with them requiring such capital injections when necessary. Under the Dodd-Frank Act, as described earlier, if an insured depository institution is not the subsidiary of a bank holding company or an S&L holding company, the appropriate federal regulator for the insured depository institution will require any company that directly or indirectly controls the insured depository institution to serve as a source of financial strength for the insured depository institution. Although FDIC and OCC can take enforcement action against holding companies that engaged in unsafe and unsound practices affecting the exempt institution, they do not have the same authority as the Federal Reserve to set and enforce minimum capital levels on holding companies.

Federal Regulation of Exempt Institutions Differs across Regulators, and Views on Regulatory Adequacy Are Mixed

Federal regulation of exempt institutions differs across the banking regulators and is evolving. However, views on the adequacy of the regulation varied with FDIC and OCC and regulated institutions viewing it as adequate and the Federal Reserve and Treasury viewing it as lacking.

³⁷Prior to the Dodd-Frank Act, the Federal Reserve required bank holding companies to serve as a source of strength as a matter of policy. Section 616(d) of the Dodd-Frank Act codified and enhanced that source of strength principle and applies it to S&L holding companies and to insured depository institutions that are not subsidiaries of bank holding companies or S&L holding companies. The Dodd-Frank Act defines source of strength as the ability of a company that directly or indirectly controls an insured depository institution to provide financial assistance to such insured depository institution in the event of financial distress. In addition to expanding the scope of the coverage to include any company that controls an insured institution, the Dodd-Frank Act requires the banking regulators to issue joint rules to implement the statute by July 21, 2012.

Supervision of ILCs and Limited-Purpose Credit Card Banks Focuses on the Institutions' Financial Condition

FDIC and OCC, which oversee ILCs, limited-purpose credit card banks, and trust banks, are focused primarily on the safety and soundness of the exempt institutions. To carry out its supervisory responsibilities, FDIC generally conducts annual full-scope examinations of ILCs and state-chartered limited-purpose credit card banks jointly with the state regulators and assigns each a CAMELS rating.³⁸ OCC examines federally chartered limited-purpose credit card banks every 12-18 months.

FDIC and OCC focus on the exempt institutions' financial health and do not have the statutory authority to examine all relationships within the holding company structure that could pose risks to the exempt institution. However, beyond its focus on the insured institutions' safety and soundness, we found that FDIC examiners look at the exempt institutions' affiliate relationships as part of the examination. In particular, from our selected review of 11 examination reports that FDIC conducted of ILCs in 2008 through 2011, we found that FDIC examiners reviewed transactions between the ILCs and their affiliates.³⁹ For example, most of the examination reports described the various affiliates, including holding company structure and affiliate transactions. According to FDIC's *Risk Management Manual of Examination Policies*, examiners should look at the affiliate transactions to determine whether the terms of these transactions are comparable to the terms of similar nonaffiliate transactions. FDIC examination reports included information on affiliate relationships and transactions and oversight of the exempt institution and, for most of the reports we reviewed, FDIC did not raise any issues with affiliate transactions. However, in one case FDIC noted that the exempt institution had used an affiliate for critical activities and in another reported a violation relating to affiliate transactions to an ILC because its parent holding company had used some of the ILC's assets as collateral. After FDIC had issued a recommendation that the management should

³⁸The CAMELS rating system comprises Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Risk.

³⁹We reviewed a total of 18 examinations of exempt institutions with assets of \$1 billion or more that FDIC and OCC conducted in 2010 and 2011. We chose examinations of the largest banks (by asset size) because these institutions represented a greater financial risk. FDIC has statutory authority to examine any affiliate of a state nonmember bank (including an ILC) as necessary to determine the relationship of that affiliate to the bank and the effect of that relationship on the bank. 12 U.S.C. § 1820(b)(4). Only one limited-purpose credit card bank that OCC supervised had assets of \$1 billion or more, which was one of our criteria for choosing examinations to review. Therefore, we judgmentally selected six other examinations, selecting the most recent examinations.

ensure that affiliate agreements with third parties do not cause the bank's assets to be placed at risk, the ILC management sought reimbursement from the affiliate.

Although OCC officials told us that affiliate transactions were reviewed for limited-purpose credit card banks and were considered an important part of the onsite examination, our analysis of seven OCC examination reports showed that affiliate transactions were generally not discussed in detail. According to an OCC lead examiner for credit card banks, aspects of affiliate transactions were included as part of their review of audit, earnings, and management for each of the limited-purpose credit card banks. Because many of the limited-purpose credit card banks rely on the holding company to provide funding for the receivables on a daily basis, the examiners review the transactions to ensure that they are in compliance with the law. The OCC examiner told us that if the examiners had not found any problems with affiliate transactions, the transactions would not be discussed in the reports. However, one examination report noted that a limited-purpose credit card bank had poor documentation relating to its affiliate transactions and had paid an above-market rate to the holding company on a bank deposit.

Oversight of S&Ls Is Evolving and Will Likely Differ from Previous Regulation

The oversight of S&Ls and their holding companies is evolving, with the significant changes likely occurring at holding company level. As of July 21, 2011, the Federal Reserve assumed responsibility for supervising S&L holding companies in accordance with the Dodd-Frank Act. The Federal Reserve plans apply certain elements of its consolidated supervisory program for bank holding companies to S&L holding companies.⁴⁰ The consolidated supervision program, which applies primarily to large and regional bank holding companies, is aimed at assessing and understanding the bank holding company on a consolidated basis. In April 2011, the Federal Reserve issued a notice of intent to provide information to the S&L holding companies on how it plans to supervise them and to solicit feedback. The notice covered consolidated supervision, the holding company rating system, capital

⁴⁰As the prior regulator of S&L holding companies, OTS had the authority to supervise the entire S&L holding company organizations and was considered a consolidated supervisor of S&L holding companies. OTS also had the authority to take enforcement actions against the holding company.

adequacy, and small noncomplex holding companies.⁴¹ In particular, the Federal Reserve stated that it intended to apply the same type of consolidated supervision to the S&L holding companies that it applied to bank holding companies and that this supervision could entail more rigorous reviews of internal control functions and consolidated liquidity compared to their previous consolidated supervision. The notice stated that the supervision may also include discovery reviews of specific activities as the Federal Reserve attempts to expand its understanding of certain types of activities.⁴² Federal Reserve officials said that the agency would issue a notice for rulemaking and request for comments once a supervisory rating system had been developed.⁴³

Federal Reserve officials also told us that the agency had organized S&L holding companies into groups based on their size and nonbanking activities for supervision purposes. Large, complex holding companies—those with \$50 billion or more in assets—will be assigned permanent onsite examination teams that will provide ongoing supervision. S&L holding companies with assets of between \$10 billion and \$50 billion will be assigned off-site examiners for monitoring that may not be continuous. For S&L holding companies with assets of less than \$10 billion, the Federal Reserve will depend largely on the primary federal regulator—either OCC or FDIC—for the exempt S&Ls. S&Ls with less than \$10 billion in assets generally consist only of the S&L and a holding company and thus require less supervision at the holding company level, according to an OCC official. Relying on the work of the primary federal regulator is similar to the Federal Reserve’s approach to supervising small “shell”

⁴¹76 Fed. Reg. 22662-22665. In July 2011 the Federal Reserve issued initial guidance concerning the Board’s supervisory approach to S&L holding companies during the first supervisory cycle. The Federal Reserve noted that it will take time for supervisory staff to better understand an S&L holding company’s operations and business model. The Federal Reserve also noted that S&L holding companies that engage in significant commercial, insurance, and broker-dealer activities may be included in separate supervisory portfolios.

⁴²A discovery review is an examination or inspection activity designed to improve the understanding of a particular business activity or control process, for purposes such as addressing a knowledge gap that was identified during the risk assessment process.

⁴³The Federal Reserve has not yet decided what type of supervisory rating system to use for the S&L holding companies but has decided against the system OTS had used, the CORE system. OTS’s CORE System was the agency’s rating system for evaluating the financial condition of the S&L holding companies. CORE means Capital, Organizational Structure, Risk Management, and Earnings.

bank holding companies. The primary federal bank regulator, either FDIC or OCC, is responsible for examining the bank, and the Federal Reserve reviews the holding company information, including financial data such as the capital and liquidity levels and the quality of the risk management at the holding company level.⁴⁴

While the Federal Reserve plans to use its consolidated supervisory program for S&L holding companies, it still must decide how it plans to supervise grandfathered unitary S&L holding companies that engage in commercial activities. Federal Reserve officials acknowledged that the regulation and the supervision of grandfathered unitary S&L holding companies that engage in commercial activities presented unique supervisory challenges. They said they would look at these holding companies in a broader framework than OTS had used, because that approach had covered only the impact of the holding company on the S&L. These officials said the new framework that is being developed would allow them to supervise the holding company's financial activities but not its commercial activities. As noted earlier, the Dodd-Frank Act gave the Federal Reserve the authority to decide whether the grandfathered unitary S&L holding companies should establish intermediate holding companies for their financial activities.⁴⁵ According to Federal Reserve officials, as of September 30, 2011, this decision had not been made for any of the grandfathered unitary S&L holding companies. Representatives from three grandfathered unitary S&L holding companies told us that in theory they supported the establishment of intermediate holding companies for their financial activities. But they added that their support would be contingent on the specifics of the intermediate holding company structure requirement.

⁴⁴A bank holding company might originate as a "shell" corporation organized by investors interested in purchasing a bank, or by a bank interested in reorganizing into a holding company structure in order to expand through acquisition of nonbank concerns or other banks. The management and board of directors of such a holding company are often the same as that of the bank.

⁴⁵A holding company can be organized in various ways. All holding companies have a parent company, but the structure of the overall company may consist of a number of intermediate holding companies, which in turn may hold other subsidiaries within the company. For example, GE Money Bank is an S&L that is held directly by General Electric Consumer Finance, Inc., an intermediate holding company, and the parent holding company is General Electric Company.

Conversely, the changes to the supervision of exempt S&Ls are likely to be less pronounced. OCC officials told us that they planned to supervise S&Ls in much the same way they supervised national banks and that their supervision would be the same for S&Ls owned by commercial and noncommercial holding companies. OCC will focus on the S&L—not its holding company—and use an approach that is similar to the bank supervision approach used by OCC bank examination staff. OCC has established mixed supervisory teams made up of both national bank and S&L examiners, with the goal of fostering learning and knowledge sharing on S&Ls throughout the organization.⁴⁶ In addition, OCC officials told us that they planned to work with the Federal Reserve to coordinate supervision of S&Ls and their respective holding companies. OCC officials told us that, in particular, there would be greater coordination on midsize and large S&Ls, because some overlap may exist in how these institutions are regulated.

Views on the Adequacy of Federal Regulation of Exempt Institutions Are Mixed

Representatives from the exempt financial institutions and an academic told us that the current regulatory framework was sufficiently robust. They noted that federal and state regulators were able to examine a wide variety of issues through their examination process and minimize certain risks, such as conflicts of interests between holding companies and their exempt institution subsidiaries, through the examination processes. Industry representatives also suggested that the low number of failures of exempt institutions during the last several years spoke to the robust oversight and strength of the holding company structures. According to our analysis of financial data, no limited-purpose credit card banks and two ILCs failed between 2007 and 2010, compared with hundreds of bank failures.

OCC officials told us that they had sufficient authority to examine the affiliates of national banks and could adequately examine the activities of the affiliates that may affect the bank. OCC regulatory and supervisory practices are the same regardless of whether the institution is owned by a

⁴⁶The Dodd-Frank Act included provisions governing the transfers of OTS staff to FDIC and OCC. Because all of OTS's rulemaking authority for both federal and state chartered S&Ls has been transferred to OCC, most of OTS employees were transferred to OCC, although some of OTS employees were transferred to FDIC. The Dodd-Frank Act did not specify any staff transfers to the Federal Reserve. Federal Reserve officials told us that they have hired about 25 former OTS employees to work on holding company supervision.

bank holding company or not, according to OCC officials. FDIC officials believe that they can adequately supervise exempt institutions but acknowledged the safety and soundness benefits of consolidated supervision. FDIC officials told us that they tried to ensure that institutions complied with all applicable laws and regulations and had sufficient capital. If the parent company runs into trouble, FDIC imposes certain controls through cease-and-desist orders or other enforcement measures in order to insulate the insured depository institution from the failings of its parent company. In 2005, we reported that consolidated supervision was a recognized method of supervising an insured institution, its holding company, and affiliates. We noted that while FDIC had developed an alternative approach that it claimed has mitigated losses to the bank insurance fund, it did not have some of the explicit authorities that other consolidated supervisors possess, and its oversight over nonbank holding companies may be disadvantaged by its lack of explicit authority to supervise these entities, including companies that own large and complex ILCs.⁴⁷ In 2007, FDIC officials noted in testimony that the number, size and types of commercial applicants had changed significantly causing the FDIC to carefully examine this new environment. FDIC officials further stated that these changes in ownership structures raise potential risks that deserve further study and represent important public policy issues that are most appropriately addressed by Congress.

Federal Reserve and Treasury officials contend that the exemptions represent gaps in the current regulatory structure that pose risks to the financial system. Federal Reserve and Treasury officials said while exempt institutions have access to federal deposit insurance, most are not subject to consolidated supervision. As discussed earlier, these officials believe that the lack of consolidated supervision of institutions that are federally insured represent a supervisory “blind spot” that should be removed. In particular, no federal regulator of the exempt institutions, excluding S&Ls that are part of holding companies, has the authority to broadly review the holding company and the other nonbank subsidiaries within the holding company structure. As a result, some of the potential activities within the holding company that may affect the exempt institution may be missed.

⁴⁷ GAO, *Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority*, [GAO-05-621](#) (Washington, D.C.: Sept. 15, 2005).

Treasury's 2009 regulatory reform proposal attempted to address these concerns by recommending that the exemptions to the BHC Act be removed and that companies owning ILCs, credit card banks, and trust banks become bank holding companies subject to Federal Reserve consolidated supervision.⁴⁸ With its enactment in 2010, the Dodd-Frank Act included a 3-year moratorium on approving FDIC insurance for ILCs, credit card banks, and trust banks that are directly or indirectly owned or controlled by a commercial firm. The Dodd-Frank Act also established the Financial Stability Oversight Council (FSOC), which is charged with determining whether institutions are systemically important, among other responsibilities.⁴⁹ If FSOC were to designate an exempt institution or its holding company as a systemically important nonbank financial firm, it would be regulated and supervised by the Federal Reserve. A Federal Reserve official stated that exempt institutions could be identified as systemically important nonbank financial firms. However, the official added that this designation would not address the unbalanced competition of ILCs or the other exempt institutions that would not be designated as systemically significant.⁵⁰ These ILCs holding companies would still be able to lend and issue credit through their affiliates without receiving the same supervision and regulation as bank holding companies do, according to the Federal Reserve official.

⁴⁸U.S. Department of the Treasury, *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation* (June 17, 2009).

⁴⁹Systemically important financial institutions are important large, interconnected nonbank financial companies and financial market utilities that could pose a threat to U.S. financial stability.

⁵⁰The Dodd-Frank Act created FSOC and charged it with identifying and mitigating risk to the stability of the U.S. financial system, among other duties. As part of its responsibilities, FSOC can identify nonbank financial firms as systemically important.

Removing BHC Act Exemptions Could Have Varying Implications

Removing Exemptions Would Likely Lead to Divestment or Changes in Business Models for Many Holding Companies with Exempt Institutions

According to representatives from limited-purpose credit card banks and ILCs, commercial holding companies would most likely divest themselves of their exempt institutions if the BHC Act exemptions were removed. The BHC Act restricts bank holding companies' involvement in commercial activities, among other things. Almost all representatives from exempt institutions that are owned by commercial holding companies told us that divestment was the likely outcome. For example, representatives of all five limited-purpose credit card banks and five ILCs owned by commercial holding companies that we spoke with told us that the parent companies would most likely divest, sell, or liquidate themselves of the exempt institutions. Several representatives from exempt institutions owned by noncommercial holding companies that we spoke with also told us that divestment was likely, although they identified other potential outcomes compared to their counterparts with commercial ownership. For example, three representatives from noncommercial ILCs that we interviewed told us that the holding company could be converted to a bank holding company, the ILC charter could be restructured, or the current business model could be altered to comply with BHC Act requirements. Representatives from one of the noncommercial companies we spoke with stated that the holding company's ability to compete against larger, more diversified commercial banks would be reduced. Representatives from grandfathered S&Ls owned by commercial companies similarly told us their companies would likely divest themselves of the S&L if the exemptions were removed.

Although the Federal Reserve now has the authority to require the grandfathered unitary S&L holding companies to establish intermediate holding companies, current law does not address this issue for the other institutions that are exempt from the BHC Act. We asked representatives from ILCs and credit card banks owned by both commercial and noncommercial holding companies about establishing an intermediate holding company as a potential strategy if the exemptions were removed. Approximately half of the representatives from ILCs and limited-purpose credit card banks whom we interviewed stated that they were either uncertain about or opposed to the idea of an intermediate holding

company. Some of the representatives that held this opinion argued that an intermediate holding company structure would not improve the current regulatory environment or foster greater safety and soundness within the overall holding company. However, representatives from one limited-purpose credit card bank stated that an intermediate holding company could potentially be a compromise. But they added that the utility of such an option would depend on how the policy was implemented and which financial activities were required to be conducted within the intermediate holding company.

Representatives of exempt institutions also told us that divesting the exempt institutions could have additional implications for the holding companies, their customers, and their employees.

- *Changes in business models.* Representatives from several ILCs and limited purpose credit card banks we interviewed told us that their exempt institution was an integral part of the parent holding company's business model. Specifically, they stated that the exempt institutions were used to help extend credit or streamline customer finance operations, lower lending or internal costs, or increase customer loyalty. Furthermore for some representatives, divesting their exempt institution would likely require changes in their business models or could reduce revenues for the holding company. For example, three ILCs that we spoke with indicated that divestment would result in a decrease in the parent holding companies' sales or revenue. Similarly, four of the five limited-purpose credit card banks we spoke with said that in order to continue offering credit without the BHC Act exemptions, they would likely have to use a third-party credit provider, such as one of the large banks that issue credit cards, and would lose interest and late fee income.
- *Changes in customer relationships.* Representatives from six ILCs and two credit card banks indicated that losing the financial institution could result in a significant loss of customers, damage customer relations for the parent company, or both. Officials from one ILC stated that if the holding company could no longer rely on the BHC Act exemption and divested itself of its ILC, its current customers would lose access to the revolving credit that the company issued through the ILC. Furthermore, they said that the ability to offer credit cards increased customer loyalty and provided an additional credit option for customers. Officials from a limited-purpose credit card bank reported to us that owning a financial institution allowed the holding company to retain control of the customer experience over the entire

life cycle of the transaction, from marketing to customer service and collection.

- *Increased costs of operations.* Representatives from five ILCs and one credit card bank told us that losing the exemptions could increase costs. That is, if the parent companies divested themselves of their financial institutions, the parent companies' operating or internal costs could rise because of increased administrative costs—for example, from having to use third-party credit providers. Another group of representatives told us that the ILC charter allowed the institution to market its products nationally from the state of Utah, reducing operational costs.
- *Job losses.* Representatives from two exempt institutions told us that if the BHC Act exemptions were removed and the parent company divested itself of the exempt institution, job losses would be likely at the both the financial institution and holding company levels.

Additionally, representatives from municipal deposit banks told us that their holding companies would most likely decide to divest themselves of their municipal deposit banks if the exemptions to the BHC Act were removed. Representatives of the one trust bank we interviewed told us that its parent company would likely divest itself of the insured deposits—primarily certificates of deposit—if the exemption for trust banks was removed. According to the officials of the trust bank, the insured deposits and the depository institution were a small part of their overall business, and they would be able to carry out their trust functions without the insured deposits. They said that they primarily maintained the insured depository institution because it had been a part of the organization for historical reasons.

Removing the Exemptions Would Likely Have a Limited Impact on the Overall Credit Market and Would Not Increase Concentration in Most Credit Markets

Market Shares for Exempt Institutions Limit Potential Impact on Overall Credit Market of Removing Exemptions

Removing the exemptions to the BHC Act would likely have a limited impact on the overall credit market given the small portion of the credit market that exempt institutions represent. As shown in table 4, ILCs and limited-purpose credit card banks each accounted for less than 1 percent of the loans on the balance sheets of FDIC-insured institutions in 2010, while municipal deposit banks and trust banks each accounted for no loans. In addition, S&Ls that were subsidiaries of grandfathered unitary S&L holding companies (grandfathered S&Ls) accounted for about 2.9 percent of loans, and other S&Ls accounted for about 4.6 percent of loans.⁵¹ Given the small market share of each type of exempt institution, any actions they might take if the exemptions were removed—including exiting the market altogether in the case of some grandfathered S&Ls, ILCs, and limited-purpose credit card banks—would likely have little impact on the overall credit market, at least at the national level. However, exempt institutions could have larger market shares in some regions and smaller market shares in others. To the extent that the credit market is segmented by region, the effects of removing the exemptions would likely be larger in regions where exempt institutions are a larger share of the market and smaller in regions where exempt institutions are a smaller share of the market.

⁵¹Our earlier analysis was based on total assets, this market share analysis is based on total loans, which yields slightly different percentages.

Table 4: Percentage of Total Loans and Leases on the Balance Sheets of ILCs, Limited-Purpose Credit Card Banks, Municipal Deposit Banks, and Trust Banks, as of June 30, 2010

| Exempt institution type | Percentage |
|-----------------------------------|------------|
| ILCs | 0.5% |
| Limited-purpose credit card banks | 0.1 |
| Municipal deposit banks | 0.0 |
| Trust banks | 0.0 |

Source: GAO analysis of data from FDIC, the Federal Reserve, OCC, and SNL Financial.

Note: Figures show the dollar value of total loans and leases, net of unearned income, on the balance sheets of exempt institutions as a percent of the dollar value of total loans and leases, net of unearned income, on the balance sheets of all FDIC-insured institutions. This definition of the market likely overstates exempt institutions' market shares because it excludes other providers of credit, including uninsured affiliates of FDIC-insured institutions, finance companies, credit unions, and other institutions that are not FDIC-insured.

While removing the exemptions would likely have a limited impact on the overall credit market, doing so could have a larger impact on segments of the market in which exempt institutions have larger market shares. These shares remain relatively small, however. For example, in 2010, ILCs accounted for about 1 percent of multifamily, commercial, and farm real estate loans and about 2 percent of non-credit-card consumer loans on the balance sheets of all FDIC-insured institutions, but they accounted for less than 1 percent of each of the five other types of loans we analyzed (construction and land development loans; residential mortgage loans; commercial, industrial, and agricultural production loans; credit card loans; and leases). Limited-purpose credit card banks, on the other hand, accounted for about 1 percent of credit card loans, but they accounted for less than 1 percent of construction and land development loans and almost none of any other type of loan. Grandfathered S&Ls accounted for no leases; less than 1 percent of commercial, industrial, and agricultural production loans; and for 2 to 5 percent of each other type of loan. Other S&Ls accounted for more than 9 percent of residential mortgages, less than 1 percent of credit card loans and leases, and for 1 to 5 percent of each other type of loan. Although the actions exempt institutions might take if the exemptions were removed may differ by the type of institution, the magnitude of the effects of these actions on credit markets—overall or in specific segments—are likely related to each type of exempt institution's share of the market.

Removing Exemptions Would Likely Not Affect Concentration in Overall Credit Markets

The overall credit market would likely remain unconcentrated even if exempt institutions exited the market and transferred their loans to other institutions. To assess the impact of removing the exemptions on concentration among FDIC-insured institutions, we calculated the Herfindahl-Hirschman Index (HHI), a key statistical indicator used to assess market concentration and the potential for firms to exercise market power.⁵² As shown in table 5, the HHI for the overall loan market for 2010 is well below 1,500, the threshold for moderate concentration, as are the HHIs for six of the seven specific loan markets we analyzed (credit card loans were the exception).⁵³ As a result, firms in the overall loan market and in most market segments likely have little ability to exercise market power by raising prices, reducing the quantity of credit available, reducing innovation, or otherwise harming customers. However, the HHI for the market for credit card loans is close to the threshold for moderate concentration, suggesting that one or more firms making credit card loans may have a moderate amount of market power. Furthermore, our HHIs are for the United States as a whole, and HHIs for markets in specific states or metropolitan areas within the U.S. are likely to be different.

⁵²The HHI reflects the number of firms in the market and each firm's market share, and it is calculated by summing the squares of the market shares of each firm in the market. For example, a market consisting of four firms with market shares of 30 percent, 30 percent, 20 percent, and 20 percent has an HHI of 2,600 ($900 + 900 + 400 + 400 = 2,600$). The HHI ranges from 10,000 (if there is a single firm in the market) to a number approaching zero (in the case of a perfectly competitive market). That is, higher values of the HHI indicate a more concentrated market. Department of Justice (DOJ) and Federal Trade Commission (FTC) guidelines as of August 19, 2010, suggest that an HHI between 0 and 1,500 indicates that a market is not concentrated, an HHI between 1,500 and 2,500 is moderately concentrated, and an HHI greater than 2,500 is highly concentrated, although other factors also play a role in determining market concentration. The HHI is one of the market concentration measures that government agencies, including DOJ and the FTC, use when assessing concentration to enforce U.S. antitrust laws. DOJ and FTC often calculate the HHI as the first step in providing insight into potentially anticompetitive conditions in an industry. However, the HHI is a function of firms' market shares, and market shares may not fully reflect the competitive significance of firms in the market. Thus, DOJ and FTC use the HHI in conjunction with other evidence of competitive effects when evaluating market concentration.

⁵³To calculate the HHI, we defined the market as the collection of FDIC-insured institutions. However, this definition of the market excludes many types of institutions that provide credit, including uninsured affiliates of FDIC-insured institutions, finance companies, credit unions, and other institutions that are not FDIC-insured. Capital markets are another source of funds for some market participants. Thus, the HHIs we calculate likely overstate the amount of concentration in loan markets.

Table 5: HHI of Concentration among FDIC-insured Institutions in Loan Markets, 2010

| Loan type | |
|---|-------|
| Commercial, industrial, and agricultural production loans | 443 |
| Construction and land development loans | 207 |
| Consumer loans other than credit card loans | 696 |
| Credit card loans | 1,479 |
| Leases | 712 |
| Multifamily, commercial, and agricultural real estate | 125 |
| Residential mortgages | 645 |
| Total loans and leases | 477 |

Source: GAO analysis of data from FDIC, FRB, OCC, OTS, SEC, and SNL Financial.

Note: Cells contain the HHI for loan markets, where the market is defined as the collection of FDIC-insured institutions. The HHI is calculated by summing the squared market shares of every firm in the market. We defined a firm as a group of institutions with the same parent company. For standalone institutions that do not have a parent company, the firm is the institution itself. The HHI ranges from 10,000 to a number approaching 0, with higher values indicating a more concentrated market. Department of Justice and Federal Trade Commission guidelines as of August 19, 2010, suggest that an HHI between 0 and 1,500 indicates that a market is not concentrated, an HHI between 1,500 and 2,500 indicates moderately concentrated, and an HHI greater than 2,500 indicates high concentration, although other factors also play a role in determining market concentration. This definition of the market excludes other providers of credit, including uninsured affiliates of FDIC-insured institutions, finance companies, credit unions, and other institutions that are not FDIC-insured. Our estimates may be too high or too low, depending on the numbers and sizes of the credit providers we excluded.

If the exemptions were removed, some exempt institutions might exit the credit market and stop making loans. As previously discussed, representatives from some ILCs and limited-purpose credit card banks owned by commercial parent companies indicated that their parent companies would likely divest themselves of their exempt institutions if the exemptions were removed. To estimate the effect of the divestment of grandfathered S&Ls owned by commercial companies, we estimated the change in the HHI for each loan market in alternative scenarios in which all grandfathered S&Ls, all ILCs, or all limited-purpose credit card banks ceased making loans and transferred the loans on their balance sheets to

the firms remaining in the market.⁵⁴ In the first scenario, we assumed that exiting institutions' loans were distributed proportionally among all remaining firms. In the second scenario, we assumed that the exiting institutions' loans were acquired by the largest remaining firm.⁵⁵ The estimated changes in the HHIs indicated that the overall loan market was unlikely to become concentrated in any of these scenarios. Even in the event that all grandfathered S&Ls, all ILCs, or all limited-purpose credit card banks exited the credit market, the remaining firms would still have little market power and thus little ability to increase loan prices or reduce the quantity of loans available. In every market we analyzed, except credit card loans, estimated changes in the HHIs indicated that these markets were also unlikely to become concentrated in similar scenarios. However, our definition of the market excludes other providers of credit, including uninsured affiliates of FDIC-insured institutions, finance companies, credit unions, and other institutions that are not FDIC-insured. Our estimates may be either overstated or understated, depending on the number and sizes of the credit providers we excluded.

Although available data suggest a degree of concentration in the credit card loan segment, the likely impact of removing the exemptions on this market varies across institution types. We found that the HHI for the market for credit card loans in 2010 was close to the threshold for moderate concentration. However, under current conditions, estimated changes in the HHI were small—less than 100—in scenarios in which all

⁵⁴These scenarios do not apply to S&Ls that are not subsidiaries of grandfathered unitary S&L holding companies because these S&Ls are either not subsidiaries of holding companies or are subsidiaries of nongrandfathered S&L holding companies. S&Ls that are not subsidiaries of holding companies do not have a holding company that would be affected if the exemptions were removed. S&L holding companies that are not grandfathered unitary S&L holding companies are subject to activity restrictions that are similar to those for financial holding companies and cannot engage in commercial activities. These S&L holding companies would likely have to make fewer adjustments to their activities than grandfathered unitary S&L holding companies that engage in commercial activities or parent companies of ILCs and limited-purpose credit card banks that engage in commercial activities if the exemptions were removed.

⁵⁵Exempt institutions and their parent companies have a variety of options for complying with the BHC Act in the event that the exemptions are removed. The likelihood that an exempt institution will exit the credit market depends on a variety of factors, including its specific exemption, whether or not it has a parent company, and, if it does, the type of activities in which its parent company engages. Thus, the purpose of this exercise is to establish an upper bound on the effect that removing the exemptions is likely to have on credit market concentration.

ILCs or all limited-purpose credit card banks ceased making loans and transferred their portfolios to other FDIC-insured institutions. Removing the exemptions for these institutions would likely not lead to significant increases in market power in the credit card loan market. In contrast, the HHI for the credit card loan market increased by more than 100 in scenarios in which grandfathered S&Ls ceased making credit card loans and transferred their portfolios to other FDIC-insured institutions. In these scenarios, the increase in concentration in the credit card loan market could be large enough to significantly increase market power for some of the remaining firms and might lead to price increases or reductions in availability of credit card loans. Once again, this definition of the market excludes other providers of credit, including uninsured affiliates of FDIC-insured institutions, finance companies, credit unions, and other institutions that are not FDIC-insured. Our estimates may be either overstated or understated, depending on the number and sizes of the credit providers we excluded.

Exempt Institutions Expressed Concerns about the Impact on Certain Markets of Removing the Exemption

Some representatives of exempt institutions also expressed concern that removing the exemptions could increase concentration in the market for credit card loans and reduce the availability of credit in certain niche markets. Representatives from five limited purpose credit card banks and several ILCs and their parent companies reported that if the exemptions were removed, the parent company would most likely divest itself of the credit card bank or ILC rather than convert to a bank holding company. As a result of divestment, some stated that their credit portfolios would most likely be acquired by large credit card issuers or banks, argued that divestment BHC Act exempt institutions could potentially increase credit market concentration, or restrict access to credit for some customers. Two exempt institutions said that credit to borrowers with limited access to general purpose credit would be affected.

Representatives from several ILCs and two credit card banks also told us that they made a significant proportion of loans in niche markets, including student loans, small business loans, and vehicle and equipment loans and leases to businesses and consumers involved in activities such as specialized retail sales, insurance, transportation services, and taxi cab operations. Representatives from 3 exempt institutions and their parent companies also indicated that they offered specific credit products that commercial banks did not offer and served customers that commercial banks typically did not serve. One large credit card issuer told us that it

had developed cobranded credit card arrangements for certain businesses, such as a small customer machinery tool manufacturer, and designed programs to serve a particular demographic for a particular retailer.⁵⁶ This credit card issuer told us that it had invested substantial resources in developing a user friendly, secure, and reliable nationwide structure customized to a particular group in order to win cobranding relationships with retailers in niche markets. However, one academic we spoke with said that traditional banks and other lenders would likely not expand into niche consumer credit markets, because these institutions lacked the market expertise of such credit card banks and ILCs. The lack of data on activity in niche markets prevented us from measuring concentration and estimating potential changes to it in scenarios in which exempt institutions ceased to make loans. Representatives from some exempt institutions also expressed concerns about the availability of credit to certain niche markets if the exemptions were removed.

Federal Reserve officials told us that they believed that credit would continue to be available to creditworthy customers, even if the exemptions were removed and some institutions no longer provided credit. When we discussed the issue of credit availability in niche markets with the Federal Reserve, an official explained that the agency generally used FDIC's Call Report data to analyze credit markets and that the reports did not include data on niche credit markets. Although Federal Reserve officials acknowledged that removing the exemptions for credit card banks and ILCs could affect the price and quantity of credit available in some niche markets in which those institutions operated, they expected that other financial institutions would step in and make credit available to qualified borrowers at prices determined by the market. The officials stated that they had not seen any data supporting the idea that exempt institutions offered better terms than commercial banks. Moreover, they stated that companies that currently owned exempt institutions could continue to provide credit to their customers through institutions without insured deposits, such as finance companies, which are not permitted to have insured deposits. One example of this type of nonbank finance company is the Ford Motor Credit Company, a wholly owned subsidiary of

⁵⁶Cobranded credit cards involve partnerships between financial institutions and unaffiliated organizations, generally for-profit organizations such as airlines, automobile manufactures, and retailers. Like an affinity program, a contractual agreement governs the cobranded relationship, and the cobranded card usually carries the partner's logo.

the Ford Motor Company that finances Ford automobiles and supports Ford dealers but does not accept FDIC-insured deposits.

Views Varied on How Removing the Exemptions Would Impact Institutions' Safety and Soundness and Financial System Stability

Representatives from three exempt institutions stated that if the exemptions were removed, they would see no additional improvement in safety and soundness. Other exempt institution representatives explained that they did not consider consolidated supervision a stronger model than the FDIC and state regulator model for exempt institutions. In addition to not improving safety and soundness, some representatives from exempt institutions stated that removing the exemptions would likely result in further credit market concentration. For example, representatives from a limited-purpose credit card bank noted that their share of the market would likely be absorbed by large credit card issuers as their holding company would likely divest their institution if the exemptions were removed.

OCC officials have not expressed concerns about the sufficiency of the current oversight of exempt institutions and FDIC officials acknowledged the safety and soundness benefits of consolidated supervision. Federal Reserve and Treasury officials maintained that the safety and soundness of exempt institutions would be improved if the BHC Act exemptions were removed because exempt institutions—and their holding companies—would be subject to consolidated supervision. Consolidated supervision allows regulators to understand an organization's structure, activities, resources, and risks, and to address financial, managerial, operational, or other deficiencies before they pose a danger to subsidiary depository institutions. However, Federal Reserve officials acknowledged that consolidated supervision needed to be improved in light of the financial problems experienced by several bank holding companies during the 2007-2009 financial crisis but noted that they had learned many lessons from the crisis. For example, according to the Federal Reserve officials, regulated institutions, particularly large U.S. banking organizations, had complained to federal banking regulators, including the Federal Reserve, about unregulated entities taking over more of their business. Their concerns and influence contributed to a less than a rigorous application of safety and soundness standards by federal regulators, which was one of the causes for the recent financial crisis. Representatives from a former ILC holding company that became a bank holding company agreed with the Federal Reserve and Treasury's view on the merits of subjecting exempt institutions to consolidated supervision, noting, for example, that their holding company was now required to implement more robust risk management systems than it had previously maintained.

Federal Reserve officials also stated that financial system stability would improve if the exemptions from the BHC Act were removed. They noted that the risk posed by the exempt institutions should not be discounted based on their relative size and small number of the institutions, as the size and number of the institutions could change in the future. For example, Federal Reserve officials told us that if the exemption were not removed and the Dodd-Frank moratorium expired, the number and size of ILCs could grow to the much higher levels that they had reached prior to the financial crisis. Furthermore, Federal Reserve officials noted that maintaining these exemptions resulted in differing regulatory oversight, raising questions about whether the exemptions provide an unfair competitive advantage. For example, holding companies of exempt institutions (aside from S&L holding companies) are not subject to the same level of scrutiny as bank holding companies—despite enjoying the benefits of being FDIC insured. Federal Reserve officials also cited other potential competitive concerns introduced by maintaining the exemptions. For example, a large company that owns an exempt insured depository institution could direct that institution to (unfairly) deny credit to the parent company's competitors. Moreover, the parent company could encourage the affiliated exempt insured depository institution to offer loans to the company's customers based on terms not offered to its competitor's customers.

The impact of removing the exemption and addressing risks posed by exempt institutions varies. For example, the Dodd-Frank Act requires the holding companies for S&Ls, which are by far the largest in number and size, to be supervised by the Federal Reserve. S&L holding companies will be subject to capital requirements and other regulatory requirements similar to those applicable to bank holding companies. In contrast, the other exempt institutions are few in number and size, but their holding companies are not subject to Federal Reserve's supervision. In addition, the banking activities of the exempt institutions vary—for example, ILCs conduct activities similar to those of full-service commercial banks and limited-purpose credit card banks conduct few banking activities—and these activities carry different risks. The moratorium on approving federal deposit insurance for ILCs, credit card banks, and trust banks is set to expire in 2013. Federal Reserve officials told us that they plan to continue to watch changes in the number or size of exempt institutions, as they have previously, consistent with their position that the exemptions represent gaps in the regulatory structure which may pose risks to the financial system. They also said they would bring forward any concerns about exempt institutions which may pose a risk to financial system stability to FSOC. Ultimately, the decision to remove the BHC Act

exemptions is a policy decision that involves trade-offs among a number of competing considerations, including potentially increasing concentration in certain credit markets and decreasing consumer choice and the availability of credit in certain regions and credit markets and addressing existing regulatory gaps and potential competitive impacts.

Agency Comments and Our Evaluation

We provided a draft of this report to the Federal Reserve, FDIC, OCC, the New York State Department of Financial Services, and Treasury for their review and comment. Treasury provided written comments that have been reprinted in appendix III. Treasury agreed with our description of the agency's views on the exemption from consolidated Federal Reserve supervision for holding companies owning companies exempt from the BHC Act definition of bank. In addition, Treasury noted that it recommends that the appropriate federal agencies maintain continued oversight to the extent legally permissible within their respective existing authorities over all holding companies owning insured depository institutions. We also received technical comments from the New York State Department of Financial Services, FDIC, and OCC, which we incorporated as appropriate.

We are sending copies of this report to the appropriate congressional committees and to the relevant agencies. This report will also be available at no charge on our website at <http://www.gao.gov>.

Should you or your staff have questions concerning this report, please contact me at (202) 512-8678 or clowersa@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix IV.



A. Nicole Clowers
Director
Financial Markets and
Community Investment

Appendix I: Objectives, Scope, and Methodology

This report examines (1) the number of certain institutions in the U.S. banking system that are exempt from the definition of bank in the Bank Holding Company Act (BHC Act) and identifies general characteristics of these institutions; (2) the federal regulatory system for the exempt financial institutions and views of exempted entities; and (3) the potential implications of subjecting holding companies for the exempt institutions to the BHC Act relating to the types of activities in which such institutions and their holding companies may engage, the availability and allocation of credit, the stability of the financial system and the economy, and the safe and sound operations of such institutions.

Number of Institutions and General Characteristics

To determine the extent to which certain financial institutions were exempt from the BHC Act, we requested data from Federal Deposit Insurance Corporation (FDIC), Board of Governors for the Federal Reserve System (Federal Reserve), Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) relating to the number of exempt institutions, their geographic location, their asset size, and the parent holding company. We also interviewed officials from the FDIC and OCC to obtain their understanding of the exemptions listed in the BHC Act. Once we established the type of institutions that were exempted from the BHC Act, we collected data from the FDIC, Federal Reserve, and OCC on these institutions from 2006 through 2010. The data included: asset size, geographic location, and primary federal regulators. We also interviewed the state banking departments of California, Nevada, New York, and Utah to collect information on the industrial loan companies (ILC) and municipal deposit banks, which are exempt from the definition of bank under the BHC Act and are state-chartered institutions. We tested the reliability of the data provided to us by the federal banking regulators and determined it to be sufficiently reliable for our purposes. To do this, we interviewed the regulators on how they identified institutions that were exempt from the BHC Act and what process they used to identify the institutions and then compared the lists from the federal banking regulators. As part of this comparison, we looked for any duplicates or inconsistency between the regulators.

To determine whether ILCs, limited-purpose credit card banks, municipal deposit banks, and trust banks were owned by commercial holding companies, we reviewed information from the federal bank regulators on the holding companies of the exempt institutions and analyzed public information, if available, on the holding companies to identify the business segments of the company. The types of publicly available information that we examined included Securities and Exchange Commission's (SEC)

filings and company annual reports. Using this information, we identified the annual gross revenue and the business segments that created the revenue. Using the activities listed in Section 4 (k) of the BHC Act, we compared the activities of the holding company listed in the public documents to identify the activities considered financial in nature and then determined the extent to which their 2010 annual gross revenue was produced by financial activities. In accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act, if 15 percent or more of a company's activities were financial, we classified it as noncommercial. Companies that derived less than 15 percent of their revenue from financial activities were classified as commercial.

Federal Regulatory System

To describe the federal regulatory system for the exempt financial institutions, we reviewed 18 examinations of exempt institutions with assets of \$1 billion or more that FDIC and OCC conducted in 2009 and 2010. We selected examinations for review based on the institutions' asset size, choosing larger institutions because of the potential risks they posed. The examinations we reviewed included 11 ILCs and 7 limited-purpose credit card banks. Of the OCC-supervised limited-purpose credit card banks, only one institution met our criteria so we reviewed the most recent examinations of the OCC-supervised limited-purpose credit card banks. Our review of examinations did not include trust banks and municipal deposit banks because their asset sizes were much lower than \$1 billion. We focused on the larger institutions because we determined that the regulators generally dedicated more resources to them, such as placing examiners onsite and concluded that if certain supervisory practices are not taken on the larger institutions, then they would not likely be implemented for the smaller institutions. We reviewed documentation from FDIC, the Federal Reserve, and OCC about their supervision practices, including information from both OCC and the Federal Reserve on how they plan to carry out their new responsibilities for savings and loans (S&L) and their holding companies. We interviewed officials from FDIC, the Federal Reserve, OCC, and OTS regarding the supervision of all BHC Act exempt institutions, including S&L and holding

company supervision and an academic who recently completed a study on ILCs for a think tank organization.¹

Implications of Removing Exemptions

To assess the extent to which credit markets are likely to be affected if the exemptions are removed, we calculated market shares for each type of exempt institution in loan markets as of June 30, 2010. We defined the market as the collection of all FDIC-insured institutions for which we could obtain balance sheet data as of June 30, 2010.² We obtained lists of FDIC-insured institutions from the Summary of Deposits (SOD) data available on FDIC's website. We obtained balance sheet data from each institution's Call Report or Thrift Financial Report from SNL Financial, a financial industry database. Some institutions indicated that they were subsidiaries of other institutions in the data and that their parent institution reports consolidated balance sheet data for both institutions on the parent institution's balance sheet. In these cases, we removed the subsidiary institution from the sample in these cases to avoid double-counting them.

We identified seven groups of institutions: (1) commercial banks and all subsidiaries of bank holding companies, (2) limited-purpose credit card banks, (3) ILCs, (4) municipal deposit banks, (5) trust banks, (6) S&Ls that are subsidiaries of grandfathered unitary savings and loan holding companies ("grandfathered S&Ls"), and (7) other S&Ls. All institutions that are subsidiaries of bank holding companies are in the first group. The two groups of S&Ls are distinguished by the types of holding companies of which they are subsidiaries. Prior to the enactment of the Gramm-Leach-Bliley Act (GLBA) in 1999, unitary S&L holding companies could generally operate without activity restrictions. GLBA restricted companies that filed applications to acquire an S&L after May 4, 1999, to only engage in activities permissible for S&L holding companies. Existing unitary S&L holding companies were "grandfathered" and could continue to engage in any type of financial or commercial activities. Thus, some S&Ls are subsidiaries of grandfathered unitary S&L holding companies that are not subject to activity restrictions, while other S&Ls are either

¹As of July 21, 2011, the Dodd-Frank Act abolished OTS, which formerly had the authority to regulate and supervise federally chartered savings and loans associations and all S&L holding companies and OTS was officially dissolved 90 days later (Oct.19, 2011).

²SNL Financial is a private database of financial data of banking, financial services, insurance and real estate.

subsidiaries of holding companies that are subject to activity restrictions or are not subsidiaries of holding companies.

We obtained lists of limited-purpose credit card banks, ILCs, municipal deposit banks, and trust banks as of September 30, 2010, or December 31, 2010, from FDIC, the Federal Reserve, and OCC. We then used institution histories obtained from FDIC's Bank Find website (Bank Find) to adjust those lists to reflect institutions' types as of June 30, 2010. We used FDIC's SOD data to identify S&Ls. To further identify grandfathered S&Ls, we obtained a list of grandfathered unitary S&L holding companies and their subsidiaries as of December 31, 2010, from OTS. Because the unitary S&L holding companies were grandfathered in 1999, the savings and loans that were their subsidiaries as of December 31, 2010, must also have been their subsidiaries as of June 30, 2010. That is, an S&L could not have become a subsidiary of a grandfathered unitary S&L holding company between June 30, 2010, and December 31, 2010. Finally, we used FDIC's SOD data to identify commercial banks and all institutions that are subsidiaries of bank holding companies. All institutions that are subsidiaries of bank holding companies—including limited-purpose credit card banks, ILCs, municipal deposit banks, S&Ls, and trust banks—are put in the group containing commercial banks and bank holding company subsidiaries.

We estimated each group's share of the market for various types of loans, including total loans and leases; construction and land development loans; residential mortgage loans, multifamily, commercial, and agricultural real estate loans; commercial, industrial, and agricultural production loans; credit card loans; consumer loans other than credit card loans; and leases. A group's market share is equal to the total dollar value of loans on the balance sheets of all institutions in the group as a percent of the total dollar value of loans on the balance sheets of all institutions in the market.

To assess the extent to which the price of credit and the quantity of credit available are likely to be affected if the exemptions are removed, we calculated the Herfindahl-Hirschman Index (HHI) of market concentration in loan markets. The HHI is a key statistical indicator used to assess the market concentration and the potential for firms to exercise market power. The HHI reflects the number of firms in the market and each firm's market share, and it is calculated by summing the squares of the market shares of each firm in the market. For example, a market consisting of four firms with market shares of 30 percent, 30 percent, 20 percent, and 20 percent has an HHI of 2,600 ($900 + 900 + 400 + 400 = 2600$). The HHI ranges

from 10,000 (if there is a single firm in the market) to a number approaching zero (in the case of a perfectly competitive market). That is, higher values of the HHI indicate a more concentrated market. Department of Justice and Federal Trade Commission guidelines as of August 19, 2010, suggest that an HHI between 0 and 1,500 indicates that a market is not concentrated, an HHI between 1,500 and 2,500 indicates that a market is moderately concentrated, and an HHI greater than 2,500 indicates that a market is highly concentrated, although other factors also play a role in determining market concentration.

To calculate HHIs, we defined a firm as the collection of all FDIC-insured institutions that are subsidiaries of the same parent company (for institutions that are subsidiaries of parent companies) or the institution itself (for institutions that are not subsidiaries of parent companies). Parent companies of FDIC-insured institutions are either bank holding companies, S&L holding companies, or other parent companies. We identified bank holding company parents and all their subsidiaries for each year using FDIC's SOD data. We obtained lists of S&L holding company parents and their OTS-regulated subsidiaries from OTS. Based on data for 2011, we assumed that each savings bank that is not a subsidiary of a bank holding company is either a standalone institution without a parent company or is the only FDIC-insured subsidiary of its parent holding company. We obtained data on other parent companies—the nonbank holding company, non-S&L holding company parent companies of some credit card banks, industrial loan companies, and trust banks—for 2010 from FDIC and OCC. A limitation of this strategy is that we may not have identified all the institutions that belong to the same other parent company. As a result, our HHIs may understate the amount of concentration in the market.

We calculated the HHI for the markets for various types of loans, including total loans and leases; construction and land development loans; residential mortgage loans; multifamily, commercial, and agricultural real estate loans; commercial, industrial, and agricultural production loans; credit card loans; consumer loans other than credit card loans; and leases. We first calculated each firm's market share as the total dollar value of loans on the balance sheets of all institutions in the firm as a percent of the total dollar value of loans on the balance sheets of all institutions in the market. We then summed the squared market shares of every firm in the market to obtain the HHI for that market.

For groups composed of grandfathered S&Ls (part of a unitary S&L holding company), ILCs, and limited-purpose credit card banks, we

estimated the change in the HHI for each loan market in alternative scenarios in which each group of exempt institutions ceases to make loans and transfers the loans on its balance sheets among firms in the market. In the first scenario, we assumed that the exiting institutions' loans are distributed proportionally among remaining firms. In the second scenario, we assumed that the exiting institutions' loans are acquired by the largest firm remaining in the market.

A limitation of including only FDIC-insured institutions in our market share and HHI calculations is that we exclude many institutions that do not have FDIC insurance but that provide credit, such as uninsured affiliates of FDIC-insured institutions, credit unions, and finance companies. Capital markets are another source of funds. Thus, our calculations may overstate exempt institutions' share of loan markets. Furthermore, our calculations may either overstate or understate the amount of concentration in loan markets, depending on the numbers and sizes of the firms we are excluding.

Our analysis implicitly assumes loan markets are national markets, that is, that credit provided by an institution is available to any potential borrower, regardless of their respective geographic locations. We make this assumption because subnational loan data are not readily available. If loan markets are not national in scope, then our market share and market concentration estimates are unlikely to represent those that we would estimate for a specific subnational geographic region, such as a state or metropolitan area. The market share and market concentration estimates for some regions would likely be greater than our national estimates, while others would likely be lower.

We assessed the reliability of all of the data used to determine the potential implications of removing the exemptions and found that the data were sufficiently reliable for our purposes. To do this, we interviewed the regulators on how they identified institutions that were exempt from the BHC Act and what process they used to identify the institutions and then compared the lists from the federal banking regulators.

In addition to these quantitative analyses, we interviewed representatives from 31 exempt institutions and representatives from the American Bankers Association and the Independent Community Bankers Association to learn more about their views regarding the BHC Act exemptions and possible implications of the institutions losing their exempt status. In addition, we interviewed representatives from two ILC holding companies that recently became bank holding companies to

obtain their views on bank holding company supervision from the perspective of a former ILC holding company. We selected the institutions for interview based primarily on the size of the exemption institutions and the commercial status of the holding company. We attempted to interview the largest institutions and those which were held by holding companies that would be considered commercial. We conducted a content analysis of the qualitative information that we obtained from these interviews to identify themes that emerged. We also interviewed FDIC, Federal Reserve, OCC and Department of the Treasury officials to obtain their views on the implications of removal the exemptions. In addition, we interviewed three commercial banks, which are large credit card issuers, to collect additional information on potential concentration in credit card issuing if the exemptions were removed.

We conducted this performance audit between October 2010 and January 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Financial Institutions Exempt under the Bank Holding Company Act and the Holding Company Commercial Status

Certain companies are exempt from the regulation as bank holding companies under the Bank Holding Company Act (BHC Act) because their subsidiaries do not meet the definition of a “bank” under the BHC Act. These exempt institutions include savings and loans (S&L), industrial loan corporations, limited-purpose credit card banks, municipal deposit banks, and trust banks. While S&L holding companies are not regulated under the BHC Act, after the Dodd-Frank Act, their treatment will be similar to that of bank holding companies. Therefore, we exclude S&Ls from this analysis. We identified 57 exempt institutions: 34 industrial loan corporation (ILC), 10 limited-purpose credit card banks, 10 municipal deposit banks, and 3 trust banks.

Industrial Loans Corporations

Excluding S&Ls, ILCs comprise the largest number of institutions that rely on the BHC Act exemption. As of September 30, 2011, there were 34 ILCs (see table 6).

Table 6: Industrial Loan Corporations, as of September 30, 2011

| Name | City | State | Assets (in millions) | Holding company |
|---|------------------|-------|----------------------|-----------------|
| UBS Bank USA | Salt Lake City | UT | \$31,465.2 | Noncommercial |
| USAA Savings Bank | Las Vegas | NV | 13,957.3 | Noncommercial |
| Capmark Bank | Midvale | UT | 6,721.8 | Noncommercial |
| BMW Bank of North America | Salt Lake City | UT | 9,320.6 | Noncommercial |
| Sallie Mae Bank | Murray | UT | 6,524.5 | Noncommercial |
| GE Capital Financial | Salt Lake City | UT | 8,423.8 | Noncommercial |
| CapitalSource Bank | Los Angeles | CA | 6,371.8 | Noncommercial |
| Beal Bank | Las Vegas | NV | 5,958.1 | Noncommercial |
| Woodlands Commercial Bank | Salt Lake City | UT | 2,160.8 | Noncommercial |
| Optumhealth Bank | West Valley City | UT | 1,720.8 | Noncommercial |
| Merrick Bank | South Jordan | UT | 1,148.3 | Unknown |
| Wright Express Financial Services Corporation | Midvale | UT | 1,365.4 | NonCommercial |
| Toyota Financial Savings Bank | Henderson | NV | 799.9 | Commercial |
| Centennial Bank | Fountain Valley | CA | 728.6 | Noncommercial |
| Pitney Bowes Bank | Salt Lake City | UT | 749.7 | Commercial |
| Fireside Bank | Pleasanton | CA | 276.1 | Noncommercial |

**Appendix II: Financial Institutions Exempt
under the Bank Holding Company Act and the
Holding Company Commercial Status**

| Name | City | State | Assets (in millions) | Holding company |
|------------------------------------|----------------|--------------|-----------------------------|------------------------|
| Finance Factors | Honolulu | HI | 537.2 | Unknown |
| Medallion Bank | Salt Lake City | UT | 601.1 | Noncommercial |
| Transportation Alliance Bank | Ogden | UT | 537.9 | Unknown |
| World Financial Capital Bank | Salt Lake City | UT | 596.9 | Noncommercial |
| First Security Business Bank | Orange | CA | 490.4 | Noncommercial |
| Community Commerce Bank | Claremont | CA | 340.0 | Unknown |
| Enerbank USA | Salt Lake City | UT | 436.4 | Commercial |
| Circle Bank | Novato | CA | 305.5 | Noncommercial |
| Celtic Bank | Salt Lake City | UT | 219.5 | Unknown |
| Balboa Thrift and Loan | Chula Vista | CA | 202.0 | Unknown |
| Finance & Thrift Co. | Porterville | CA | 124.7 | Noncommercial |
| WebBank | Salt Lake City | UT | 77.9 | Noncommercial |
| LCA Bank Corporation | Park City | UT | 65.1 | Unknown |
| Rancho Santa Fe Thrift and Loan | San Marcos | CA | 42.9 | Unknown |
| Target Bank | Salt Lake City | UT | 43.3 | Commercial |
| Minnesota First Credit and Savings | Rochester | MN | 28.6 | Unknown |
| Eaglemark Savings Bank | Carson City | NV | 39.1 | Commercial |
| First Electronic Bank | Sandy | UT | 7.5 | Unknown |
| Total assets | | | \$102,389.0 | |

Source: FDIC.

Note: Assets are as of June 30, 2011. FDIC is the federal regulator for all ILCs.

Limited-Purpose Credit Card Banks

Limited-purpose credit card banks are also exempt under the BHC Act. As of September 30, 2011, there were 10 limited-purpose credit card banks (see table 7).

**Appendix II: Financial Institutions Exempt
under the Bank Holding Company Act and the
Holding Company Commercial Status**

Table 7: Limited-Purpose Credit Card Banks, as of September 30, 2011

| Name | City | State | Assets (in millions) | Federal regulator | Parent company |
|----------------------------|-------------|-------|----------------------|-------------------|----------------|
| World Financial Network NB | Wilmington | DE | \$4,736.5 | FDIC | Noncommercial |
| World's Foremost Bank | Sidney | NE | 3,305.5 | FDIC | Commercial |
| TCM Bank, N.A. | Tampa | FL | 158.9 | OCC | Unknown |
| Target NB | Sioux Falls | SD | 111.9 | OCC | Commercial |
| Credit One Bank, N.A. | Las Vegas | NV | 87.0 | OCC | Unknown |
| Credit First, N.A. | Brook Park | OH | 27.0 | OCC | Commercial |
| Talbots Classics NB | Lincoln | RI | 12.1 | OCC | Commercial |
| Cedar Hill NB | Charlotte | NC | 11.3 | OCC | Commercial |
| ITS Bank | Johnston | IA | 5.4 | FDIC | Unknown |
| DSRM National Bank | Albuquerque | NM | 3.5 | OCC | Commercial |
| Total assets | | | \$8, 459.1 | | |

Sources: FDIC and OCC.

Note: Assets are as of June 30, 2011 as more recent data were not available.

Municipal Deposit Banks

Municipal deposit banks are another type of exempt financial institution. As shown in table 8, all 10 municipal deposit banks are located in New York.

Table 8: Municipal Deposit Banks, as of September 30, 2011

| Name | City | State | Assets (in millions) | Holding company |
|-------------------------------|---------------------|-------|----------------------|-----------------|
| Flushing Commercial Bank | North New Hyde Park | NY | \$567.5 | Noncommercial |
| Provident Municipal Bank | Montebello | NY | 422. 9 | Noncommercial |
| Greene County Commercial | Catskill | NY | 161.6 | Noncommercial |
| State Bank Of Chittenango | Chittenango | NY | 153.6 | Noncommercial |
| Pathfinder Commercial Bank | Oswego | NY | 52.9 | Noncommercial |
| Pioneer Commercial Bank | Troy | NY | 49.3 | Noncommercial |
| PCSB Commercial Bank | Brewster | NY | 40.3 | Noncommercial |
| WSB Municipal Bank | Watertown | NY | 32.0 | Noncommercial |
| Berkshire Bank Municipal Bank | Albany | NY | 35.5 | Noncommercial |
| Emigrant Mercantile Bank | New York | NY | 3.8 | Noncommercial |
| Total assets | | | \$1,519.4 | |

Source: New York State Department of Financial Services.

Note: FDIC is the federal regulator for all New York municipal deposit banks because they are state-chartered by the state of New York. Assets are as of June 30, 2011, as more recent data were not available.

Trust Banks

Trust banks are another type of exempt financial institution. Trust banks act as fiduciaries and as of September 30, 2011, there were three in operation (see table 9).

Table 9: Federal Chartered Trust Banks, as of September 30, 2011

| Name | City | State | Assets (in millions) | Federal Regulator | Parent company |
|---------------------------------------|-----------|-------|----------------------|-------------------|----------------|
| Invesco National Trust Company | Atlanta | GA | \$147.1 | OCC | Noncommercial |
| Legg Mason Investment | Baltimore | MD | 67.7 | OCC | Noncommercial |
| Fidelity Management and Trust Company | Boston | MA | 103.5 | FDIC | Unknown |
| Total assets | | | \$318.3 | | |

Source: OCC.

Note: Assets are as of June 30, 2011, as more recent data were not available.

Appendix III: Comments from the Department of the Treasury



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

January 13, 2012

Ms. A. Nicole Clowers
Director, Financial Markets
and Community Investment
United States Government Accountability Office
Washington, DC 20548

Dear Ms. Clowers:

The U.S. Treasury Department has reviewed the draft report of the U.S. Government Accountability Office titled, Bank Holding Company Act – Characteristics and Regulation of Exempt Institutions and the Implications of Removing the Exemptions.

We would like to take this opportunity to commend you and your staff for the thorough analysis of the issues and accurate representation of agency views on the continued exemption of holding companies owning industrial loan corporations, limited purpose credit card banks, municipal deposit banks and trust banks from consolidated Federal Reserve supervision under and the activity restrictions imposed by the Bank Holding Company Act of 1956.

As you accurately set forth in this GAO report, the Treasury Department continues to have significant concerns about the potential problems that may be caused in the future for sound oversight of the financial system, fair competition in the banking sector, and the protection of consumers in the United States. These concerns were addressed, as recognized in this GAO report, in the Treasury's 2009 white paper, U.S. Department of the Treasury, Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation, June 17, 2009. As recognized in your report, this Treasury white paper set forth Treasury's views on problems with and needed reforms to the regulation and supervision of the U.S. and international banking and financial systems in light of lessons learned from the recent financial crisis.

As your report also recognizes, Treasury in its white paper expressed concern regarding the potential future problems that could arise from the continued exemption from consolidated Federal Reserve supervision and activity restrictions of the holding companies of industrial loan corporations, limited purpose credit card banks, and other exempt companies. Treasury continues to have concerns about potential future problems from these exemptions. Accordingly, Treasury recommends that the appropriate federal agencies maintain continued oversight to the extent legally permissible within their respective existing authorities over all holding companies owning insured depository institutions.

We appreciate the opportunity to review the draft report.

Sincerely,

A handwritten signature in black ink, appearing to read 'Lance Auer', is positioned above the printed name.

Lance Auer
Deputy Assistant Secretary
Financial Institutions

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

A. Nicole Clowers, (202) 512-8678 or clowersa@gao.gov

Staff Acknowledgments

In addition to the individual named above Andrew Pauline, Assistant Director; Tarik Carter; Emily Chalmers; William Chatlos; Rachel DeMarcus; Nancy Eibeck, Fred Jimenez; Courtney LaFountain; Marc Molino; Tim Mooney; and Bob Rieke made major contributions to this report.

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