TESTIMONY OF
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BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

HEARING ON
"EXAMINING THE REGULATION AND SUPERVISION OF INDUSTRIAL LOAN COMPANIES"

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Mr. Chairman and members of the Committee:

My name is Marc Lackritz and I am President and CEO of the Securities Industry and Financial Markets Association ("SIFMA").[1] I appreciate the opportunity to testify today on the regulation and supervision of industrial banks because banks owned by SIFMA members hold the majority of all industrial bank assets in the United States.[2]

Congress passed the *Gramm-Leach-Bliley Act* ("GLBA") in 1999 to permit the widest variety of choices for affiliations between and among securities firms, banks and insurance companies. A central objective of GLBA was that each affiliated financial services entity would be functionally regulated – that is, one regulatory agency would apply the same set of rules to the same activity engaged in by any financial institution, regardless of the type of financial institution it may be. The ability to structure their operations optimally within existing law has been critical to the success of industrial

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[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers locally and globally through offices in New York, Washington D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

[2] Utah-based insured industrial banks have about $200 billion in assets, which is less than two percent of total assets of all FDIC-insured institutions. Securities firms own the largest industrial banks and, collectively, control industrial loan banks that hold more than two thirds of total industry assets and deposits. When combined with the assets and deposits of industrial banks owned by other financial services firms, such as American Express and Advanta Corp., the financial services sector of the industrial loan bank industry comprises over 80 percent of the industry.

banks and their owners. Indeed, many of these companies are among the most advanced, sophisticated, and competent providers of financial services anywhere. For that reason, SIFMA supports the ability of regulated securities firms to own industrial banks as they do under existing law.[3] We also believe any proposal to expand the existing authority of the Federal Deposit Insurance Corporation ("FDIC") over the owners of industrial banks must provide an exemption for owners who are regulated as "Consolidated Supervised Entities ("CSEs") by the Securities and Exchange Commission ("SEC").

Securities Firms' Ownership of Industrial Loan Banks

Members of the financial services community worked with Congress for decades to pass legislation to permit affiliations between and among securities firms, banks and insurance companies combined with functional regulation. After years of debate, discussion, and numerous failed attempts, Congressional leaders forged a political compromise between the relevant industries and Congress finally passed GLBA. GLBA gave financial services firms several structural options for affiliating with other firms. (1) They can choose to affiliate under a financial services holding company ("FSHC") structure regulated by the Federal Reserve Board, and each of the subsidiary financial services firms are regulated by their respective functional regulators. (2) Holding companies that own securities firms, and operate certain limited-purpose banks, can elect to be regulated as investment bank holding companies ("IBHCs"), which are subject to the jurisdiction of the SEC. (3) Securities firms and other companies can engage in banking activities through industrial loan banks and other special-purpose banks (including savings institutions, "non-bank banks," credit card banks) with supervision by the FDIC and state bank regulators. Securities firms that owned a thrift were permitted to retain their thrifts, subject to holding company supervision by the Office of Thrift Supervision ("OTS").

Although at least one securities firm (Schwab) has elected to organize as a FSHC, most of the securities firms that wanted to provide banking services chose to do so through their affiliated industrial banks. This is because they cannot own full-service commercial banks without exiting businesses that account for substantial segments of their revenues, such as commodities and merchant banking. Many SIFMA members consider these activities critical to their clients' needs and to well-functioning capital markets.

Industrial banks have a remarkably strong record of safety and financial strength. Most industrial banks, and all of the industrial banks owned by SIFMA members, are based in Utah. About 80 percent of Utah's bank assets are held in industrial banks and

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[3] As a new organization, SIFMA's Board of Directors reviewed the industrial loan bank issue prior to testifying before the House Financial Services Committee on H.R. 698 on April 25, 2007. The Board strongly supports the position outlined in this testimony, and noted the importance of dealing over the long-term with certain inconsistencies in the regulation of financial products and services (see page 6 for a fuller discussion).

most of those are held in banks owned by SIFMA members. These Utah-based industrial banks serve a nationwide market, conducting more than 95 percent of their business out of state. Utah banks are far and away the strongest in the nation with the highest aggregate tier 1 capital and return on assets.[4]

Importantly, no industrial bank in Utah has failed in the last 20 years, even in one instance when an industrial bank's holding company went bankrupt.[5] In addition, industrial banks have an exemplary record of service to their customers and the community, with nearly 40 percent of the Utah industrial banks examined by the FDIC for compliance with the Community Reinvestment Act receiving "outstanding" ratings.

Regulation of Industrial Banks and their Owners

Securities firms with industrial bank subsidiaries are subject to multiple levels of supervision. Federally insured industrial banks are subject to state banking supervision, FDIC oversight, and all banking laws governing relevant banking activities. Most importantly, the FDIC has authority to examine the affairs of any affiliate of any depository institution, including its parent company.

Securities firms' broker-dealer affiliates are regulated by the SEC, and all of the SIFMA member securities firms with industrial bank subsidiaries have elected more comprehensive enterprise-wide regulation by the SEC acting as their consolidated supervisor. The SEC's jurisdiction does not limit the concurrent authority of the bank regulators. Most of the SIFMA member securities firms that own industrial banks also own savings institutions and are regulated at the holding company level as "savings and loan holding companies" by the OTS.

The FDIC's regulation of the bank and its affiliates, combined with measures to strengthen independent control of the bank, has worked well for securities firms, their customers and shareholders, and the financial services markets. Tested for 20 years on a broad scale and under the normal stresses and market cycles, the FDIC's regulation of industrial banks has proven safe and effective. Industrial banks pose no greater safety and soundness risks than other charter types. Very simply, no case has been made to require additional constraints on the industrial bank charter beyond those imposed on other FDIC-insured institutions.

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[4] Federal Deposit Insurance Corporation *State Profile,* June 30, 2007. Utah banks' aggregate tier 1 capital was 12.01 percent; the national average is about 10 percent. Tier 1 capital is the sum of common stockholders' equity, noncumulative perpetual preferred stock (including any related surplus), and minority interests in consolidated subsidiaries, minus ineligible intangible assets. The Core Capital (Leverage) ratio is Tier 1 Capital divided by adjusted average assets, as calculated in accordance with the FDIC's Statement of Policy on Risk-Based Capital. Utah banks' return on assets was 2.14 percent; the national average was about 1 percent.

[5] The collapse in 2002 of a prominent owner of an ILC, Conseco, for business reasons unrelated to the ILC, did not adversely affect its insured ILC. CRS Report RL32767, Industrial Loan Companies/Banks and the Separation of Banking and Commerce: Legislative and Regulatory Perspectives, Jan. 3, 2007, p. CRS-8.

SEC's Holding Company Supervision Program

The SEC established its CSE framework, in part, to allow major securities firms doing business in the European Union ("EU") to comply with the requirement of the EU's "Financial Conglomerates Directive." That Directive requires that non-EU firms doing business in Europe demonstrate that they are subject to a form of consolidated supervision by their home regulator that is "equivalent" to that required of their European counterparts. A firm failing to meet that test would lose its right to operate in the European marketplace – an unacceptable outcome for firms that derive significant revenues from Europe.

As a result, in 2004 the SEC introduced a voluntary consolidated supervision regime available to certain U.S. investment banks that were not regulated by the Federal Reserve as bank holding companies.[6] (Appendix A of this statement includes a detailed description of the SEC's Consolidated Supervised Entity oversight regime).[7] While the SEC traditionally focused on compliance with the securities laws by a firm's broker-dealer, the CSE framework extends supervision to the broker-dealer's holding company and affiliates, with particular attention to capital adequacy and risk-management practices. The option to be regulated as a CSE is available only to certain highly capitalized companies; essentially, the primary broker-dealer of each CSE must maintain tentative net capital of $5 billion and submit to a number of conditions with respect to the holding company and its affiliates.[8]

The SEC has examined the five CSEs (with a focus on the unregulated material affiliates) and concluded that the firms have generally well developed internal risk management controls and are compliant with the CSE rule. The SEC will continue regular examinations, and expects "practices will continue to evolve, with CSEs remaining among the leaders in industry risk management standards."[9]

SEC Commissioner Annette Nazareth has noted that the SEC's capacity to look globally at broker-dealer holding companies has been "dramatically expanded" as a

[6] Rel. No. 34-49830 (June 8, 2004), 69 Fed. Reg. 34428 (June 21, 2004).

[7] See also Hearings before the House Subcommittee on Financial Institutions and Consumer Credit, September 14, 2006.

[8] Including, but not limited to: computing capital consistent with the CSE Rule, a group-wide internal risk management control system, group-wide procedures to detect and prevent money laundering and terrorist financing, SEC examinations, providing financial and operational information, making examinations of other regulators available to the SEC, and acknowledging that the SEC can impose additional conditions under certain circumstances.

[9] Speech by Mary Ann Gadziala, Associate Director, Office of Compliance and Examinations, SEC, before the Annual Regulatory Examination and Compliance Seminar, Institute of International Bankers, New York, NY, October 31, 2006. Available at: http://www.sec.gov/news/speech/2006/spch103106mag.htm.

result of the CSE program. The CSE approach is "similar to that applied by the banking regulators to their most complex holding companies. This convergence of approaches, spanning multiple regulatory jurisdictions and national boundaries, has been well received by the regulated entities and bodes well for greater convergence of approaches in the future."[10]

The Government Accountability Office's ("GAO") report on CSEs found that "the Federal Reserve, OTS, and SEC were generally meeting criteria for comprehensive, consolidated supervision."[11] Similarly, SEC Chairman Christopher Cox, responding to the GAO report, wrote that, "I am gratified that the GAO's report highlights many broad similarities between the Commission's CSE program and the Federal Reserve's oversight of bank holding companies, which is the obvious model for a program of this type. I am also pleased that the report recognizes certain differences between investment banks and commercial banks, and that these should be reflected in the holding company supervision provided to each type of institution."[12]

SIFMA agrees that the CSE regime is robust and comprehensive. Importantly, the SEC's CSE oversight, like the Federal Reserve's oversight of bank holding companies, meets the European Union's equivalency standard. Similarly, the standards used by the SEC for purposes of consolidated regulation closely parallel the standards used by the Federal Reserve to assess whether a foreign regulatory regime qualifies as consolidated regulation for a foreign bank operating in the United States.[13] As such, industrial bank owners that are regulated as consolidated supervised entities should not be subject to any new industrial bank holding company oversight.

This designation is critically important to the operations of many of the largest securities firms based in the United States. Failure to recognize the SEC as a consolidated regulator would diminish the agency's standing as a global regulator, particularly when it has already been recognized as such by other international regulators. In turn, the direct damage to the international operations of U.S.-based securities firms would be significant and long-lasting. As stated previously, firms would also be subject to duplicative and unnecessary holding company oversight by both the SEC and the FDIC.[14]

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[10] Speech by SEC Commissioner Annette L. Nazareth before the NABE 2006 Washington Economic Policy Conference, March 13, 2006, p. 2, Available at http://www.sec.gov/news/speech/spch031306aln_nabe.htm

[11] GAO Report 07-154, "Financial Market Regulation: Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration," U.S. Government Accountability Office, March 2007, p. 5.

[12] GAO Report 07-154, p. 77.

[13] 12 C.F.R. § 211.24(c)(ii).

[14] The SEC recognizes the importance of this designation as well. "The [CSE] rule amendments also respond to international developments. Affiliates of certain U.S. broker-dealers that conduct business in the European Union ("EU") have stated that they must demonstrate that they are subject to consolidated

Comprehensive Review of the Financial Services Regulatory Structure Needed

Technological advances, shifting demographic trends, new forms of competition, and market innovations have transformed the financial services landscape to the benefit of investors, issuers, and the industry. Over the last two decades, capital markets and the financial services industry have become truly global, integrated and interconnected. In recognition of that trend, many other industrialized countries – the United Kingdom, Germany, Japan, the Netherlands, and Australia, for example – have consolidated their financial regulatory structures to better compete in today's global financial marketplace. The United States, however, has not changed its regulatory structure substantially.

As capital markets and financial products continue to evolve, so too must our nation's regulatory system. The United States needs a regulatory regime that is capable of keeping pace with rapid globalization, technological transformations, and dynamic market changes. That is why SIFMA's new Board of Directors unanimously agreed that SIFMA should develop a long-term strategy of seeking to harmonize and rationalize financial services regulation. We have begun that process, and note that the U.S. Treasury and other financial services groups have similar projects underway. We look forward to working with all interested parties – financial market participants, regulators and legislators – to ensure a modern, innovative, and globally responsive regulatory structure.

Conclusion

Industrial banks allow SIFMA member firms to provide much-needed banking services to their customers while posing no unusual safety and soundness risk. The industrial bank industry – comprised principally of deposits in banks operated by SIFMA member firms – has developed into one of the strongest and safest group of banks that ever existed. The current model for regulation of the holding companies and affiliates has been successful.

We believe strongly that SIFMA members that own industrial banks and are subject to consolidated regulation by the SEC should not be subject to additional holding company oversight. The SEC is recognized worldwide as a consolidated regulator, and its regulatory requirements and procedures were carefully designed to comply with all standards for effective consolidated regulation in the United States and abroad. That stature should be recognized in order to ensure global securities firms are not damaged inadvertently.

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supervision at the ultimate holding company level that is "equivalent" to EU consolidated supervision. Commission supervision incorporated into these rule amendments is intended to meet this standard. As a result, we believe these amendments will minimize duplicative regulatory burdens on firms that are active in the EU as well as in other jurisdictions that may have similar laws." (Introduction to the SEC's consolidated supervision rules: *Federal Register, Vol 69, No. 118, Monday, June 21, 2004.)*

Thank you for the opportunity to testify on this important issue. We look forward to working with you, Mr. Chairman, the Committee, Congress and regulators to ensure our financial services industry retains its preeminent status in the world.

Appendix A
SEC Holding Company Supervision Program Overview

(Source: http://www.sec.gov/divisions/marketreg/hcsupervision.htm)

Consolidated Supervised Entities ("CSEs")

The Commission supervises certain broker-dealer holding companies on a consolidated basis. In this capacity, Commission supervision extends beyond the registered broker-dealer to the unregulated affiliates of the broker-dealer and the holding company itself. In supervising these Consolidated Supervised Entities ("CSEs"), the Commission focuses on the financial and operational condition of the group. The aim is to reduce the likelihood that weakness in the holding company or an unregulated affiliate endangers a regulated entity or the broader financial system. Like other consolidated supervisors overseeing internationally active institutions, the Commission requires CSEs to compute capital adequacy measures consistent with the Basel Standard.

A broker-dealer becomes a CSE by applying for an exemption from the standard net capital rule, and the broker-dealer's ultimate holding company consenting to group-wide Commission supervision (if it does not already have a principal regulator).[1]

Under the alternative method for computing capital, contained in new Appendix E to Rule 15c3-1, firms with strong internal risk management practices may utilize the mathematical modeling methods they use to manage their own business risk, including value-at-risk ("VaR") models and scenario analysis to compute deductions from net capital for market risks and exposure modeling to compute deductions for credit risks related to over-the-counter derivatives. A broker-dealer calculating net capital adequacy using the alternative method must maintain tentative net capital[2] of at least $1 billion and net capital of at least $500 million. Moreover, if the tentative net capital of a broker-dealer using this alternative method falls below $5 billion, it must notify the Commission. The Commission then would consider whether to require the broker-dealer to take appropriate remedial action.

As noted above, the associated holding company must consent to a consolidated supervision regime if it does not already have a principal regulator. The ultimate holding company must execute a written undertaking in which it agrees, among other things, to do the following:

- Maintain and document an internal risk management control system for the affiliate group;
- Calculate a group-wide capital adequacy measure consistent with the international standards adopted by the Basel Committee on Banking Supervision ("Basel Standards");
- Consent to Commission examination of the books and records of the ultimate holding company and its affiliates, where those affiliates do not have principal regulators;
- Regularly report on the financial and operational condition of the holding company, and make available to the Commission information about the ultimate holding company or any of its material affiliates that is necessary to evaluate financial and operations risks within the ultimate holding company and its material affiliates; and
- Make available examination reports of principal regulators for those affiliates that are not subject to Commission examination.

The ultimate holding company must provide the Commission with monthly, quarterly, and annual reports. The reports must include specified consolidated financial and credit risk information, including a consolidated balance sheet and income statement audited by a registered public accounting firm; the capital adequacy measurement (statements of allowable capital and allowances for market, credit, and operational risk); the results of a review by the internal auditor of the risk management and control system of the ultimate holding company; and certain reports that the ultimate holding company regularly provides to its senior management to assist in monitoring and managing risk. The ultimate holding company must make and keep current records of funding and liquidity stress tests, the basis for the determination of credit risk weights for each counterparty, the basis for the determination of internal credit ratings for each counterparty, and a record of the calculations of allowable capital and allowances for market, credit, and operational risk.

These reports will assist the Commission in monitoring the financial condition, the risk management control system, and the activities of the affiliate group to detect any events or trends that may adversely affect regulated entities or the broader financial system.

Holding Companies With Principal Regulators

To avoid duplicative or inconsistent regulation, a reduced set of requirements applies to holding companies with principal regulators associated with broker-dealers that seek to apply the alternative method of computing net capital. These holding companies must execute a written undertaking in which they agree, among other things, to do the following:

- Make available to the Commission information on controls relevant to the broker-dealer but resident in the holding company;
- Make available to the Commission information about the ultimate holding company or any of its material affiliates that is necessary to evaluate financial and operational risks within the ultimate holding company and its material affiliates; and
- Make available to the Commission capital adequacy measurements computed in accordance with the standards published by the Basel Committee on Banking Supervision and provided to the principal regulator.

CSE Supervisory Program

The Commission's supervisory program with respect to CSEs has four components:

- First, the SEC staff reviews the application prior to action by the Commission. As part of the review, the staff assesses the firm's financial position, the adequacy of the firm's internal risk management controls, and the mathematical models the firm will use for internal risk management and regulatory capital purposes. The staff also conducts on-site reviews to verify the accuracy of the information included in the application, and to assess the adequacy of the implementation of the firm's internal risk management policies and procedures.
- Second and following approval by the Commission, the SEC staff reviews monthly, quarterly, and annual filings containing financial, risk management, and operations data. These reports include consolidating financials (which show intercompany transactions that are eliminated during the preparation of consolidated financial statements) and risk reports substantially similar to those provided to the firm's senior managers. At least monthly, the holding company files a capital calculation made on a consolidated, group-wide basis consistent with the Basel Standards.
- Third, the SEC staff meets at least monthly with senior risk managers and financial controllers at the holding company level to review the packages of risk analytics prepared at the ultimate holding company level for the firm's senior management. The focus is on the performance of the risk measurement infrastructure, including statistical models; risk governance issues including modifications to and violations of risk limits; and the management of outsized risk exposures. In addition, there are quarterly meetings focused on financial results, the management of the firm's balance sheet, and, in particular, the liquidity of the balance sheet. Also on a quarterly basis, Commission staff meet with the internal auditor department to discuss implementation of the audit program as well as findings and reports that might bear on financial, operational, and risk controls. These regular discussions are augmented with focused work on risk management,

regulatory capital, and financial reporting issues of topical concern, which in some cases are pursued at several firms simultaneously.

- Fourth, the SEC staff conducts examinations of the books and records of the ultimate holding company, the registered broker-dealers (along with staff of the responsible self-regulatory organizations), and material affiliates that are not subject to supervision by a principal regulator. The examinations focus on the capital calculation and on the adequacy of implementation of the firm's documented internal risk management controls.

At present, five firms are subject to this regime: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley.

Holding Companies With Principal Regulators

The Commission's supervisory program with respect to a CSE with a principal regulator is distinct from that with respect to a CSE where the Commission has primary consolidated supervision responsibility for the holding company. The former relies significantly on the principal regulator to supervise the holding company, and thus focuses more narrowly on the broker-dealer. In general, the program in such cases consists of four parts.

- First, the SEC staff reviews the application prior to action by the Commission, as described above.
- Second and following approval, the SEC staff reviews monthly, quarterly, and annual filings containing financial, risk management, and operations data. These reports include consolidating financials (which show intercompany transactions that are eliminated during the preparation of consolidated financial statements) as well as the consolidated capital calculations filed with the principal regulator.
- Third, the SEC staff meets at least semi-annually with senior risk managers to review the packages of risk analytics prepared for the firm's senior management. The focus is on the overall performance of the risk measurement infrastructure, and especially the mathematical models used to compute deductions from net capital in the broker-dealer.
- Fourth, SEC and self-regulatory organization staff conduct examinations of the books and records of the registered broker-dealer. The examinations focus on the capital calculation and on the adequacy of implementation of the firm's documented internal risk management controls, some of which may be resident in the holding company.

This overview of the Commission's consolidated supervision program for broker-dealers and affiliates was prepared by and represents the views of the staff of the Division of Market Regulation, and does not constitute rules, regulations or statements of the Securities and Exchange Commission. For further information, contact Michael A. Macchiaroli, Associate Director, Matthew J. Eichner, Assistant Director, or Thomas K. McGowan, Assistant Director at (202) 551-5530.

[1] The definition of principal regulator contained in the rules encompasses, inter alia, the Federal Reserve and foreign supervisory regimes recognized by the Board of Governors of the Federal Reserve System ("Federal Reserve").

[2] "Tentative net capital" is defined in the CSE rules as net capital before deductions for market and credit risk.