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FDIC Final Rule: Consolidated Supervision for Industrial Banks and Industrial Loan Companies

David E. Teitelbaum, Michael D. Lewis, and Stephen Wallant*

This article explores the key changes in the Federal Deposit Insurance Corporation's Final Rule regarding "Parent Companies of Industrial Banks and Industrial Loan Companies," then summarizes the provisions retained from the notice of proposed rulemaking.

The U.S. Federal Deposit Insurance Corporation ("FDIC") adopted a Final Rule ("Final Rule") regarding "Parent Companies of Industrial Banks and Industrial Loan Companies."¹ The Final Rule largely adopts the FDIC's March 17, 2020, notice of proposed rulemaking ("NPR"),² with a handful of substantive changes. The Final Rule does not apply retroactively, nor does it apply to other forms of special charter that are exempt from the Bank Holding Company Act ("BHCA"),³ such as credit card banks and limited purpose trust companies. This article explores the key changes in the Final Rule, then summarizes the provisions retained from the NPR. The Final Rule will become effective on April 1, 2021 ("Effective Date").

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¹ <https://www.fdic.gov/news/board/2020/2020-12-15-notice-dis-b-fr.pdf> (Dec. 15, 2020); see FDIC, *Parent Companies of Industrial Banks and Industrial Loan Companies*, 86 Fed. Reg. 10,703 (Feb. 23, 2021).

² See FDIC, *Parent Companies of Industrial Banks and Industrial Loan Companies*, 85 Fed. Reg. 17,771 (Mar. 31, 2020).

³ See Competitive Equality Banking Act of 1987, Pub. L. 100-86, 101 Stat. 552 (Aug. 10, 1987) (amending BHCA definition of "bank"); 12 U.S.C. § 1841(c)(2)(H) (excepting industrial loan companies and industrial banks (each, an Industrial Bank) from BHCA definition of "bank"). To qualify for the exception, (i) the law of the chartering state must have required federal deposit insurance as of March 5, 1987, and (ii) the Industrial Bank must (A) not accept demand deposits, (B) have total assets of less than \$100 million, or (C) have been acquired prior to August 10, 1987. See 12 U.S.C. § 1841(c)(2)(H).

KEY DEPARTURES FROM THE NPR

Data Security

The Final Rule requires certain companies (“Covered Companies”) that control or propose to control, directly or indirectly, an Industrial Bank to report annually on their systems for protecting the security, confidentiality, and integrity of consumer and nonpublic personal information.⁴ This requirement is new in the Final Rule. The data security reporting obligation is not limited to data at, or received from the Industrial Bank subsidiary but rather applies “across all of a Covered Company’s financial and nonfinancial affiliates and activities” and is intended to enable monitoring for potential consumer protection risks.⁵

Moreover, per the preamble to the Final Rule, the FDIC “may consider imposing heightened requirements specific to Industrial Banks and Covered Companies regarding the use of consumer financial data for commercial purposes . . . based on the size and complexity of the Industrial Bank, the nature and scope of its activities, the sensitivity of any customer information at issue, and the unique facts and circumstances of the filing before the FDIC.”⁶

Board Representation

Covered Companies must limit their representation on each Industrial Bank subsidiary’s board to less than 50 percent rather than the 25 percent threshold under the NPR. The Final Rule clarifies that the 50 percent limitation applies to all directors, regardless of whether they are also officers of the Industrial Bank. The FDIC “retains the authority” to impose a higher threshold of director independence if deemed appropriate.⁷

FDIC Approval of New Officers and Directors

Under the Final Rule, the restriction against adding or replacing directors or senior executives without FDIC approval applies only for the first three years after granting deposit insurance or the acquisition of control by the Covered Company (whichever is later).⁸ The NPR required approval in perpetuity.

⁴ *Final Rule*, 86 Fed. Reg. at 10,718.

⁵ *Id.* at 10,725.

⁶ *Id.* at 10,711. As a potential mitigant, the FDIC says that “the rule is constructed to enable affected parties to comply with the various commitments by relying on established and ongoing reports and records, to the extent possible.” *Id.* at 10,724–25.

⁷ *Id.* at 10,719.

⁸ *Id.* at 10,721.

However, “as circumstances warrant, the FDIC may extend the three-year period or impose the restriction on a perpetual basis.”⁹

Affiliate Interlocks

The Final Rule expands the prohibition against an Industrial Bank’s appointment without FDIC approval of a senior executive officer associated with a Covered Company by imposing a three-year lookback on the senior executive officer’s relationship with an affiliate “to prevent evasion of the restriction.”¹⁰ Under the NPR, the prohibition applied only to such officers associated with the Covered Company at the time of their appointment. This prohibition applies in perpetuity.

Commitments by Covered Companies and Controlling Shareholders

The Final Rule removes the express reservation of authority to require Covered Companies or controlling shareholders to enter into written agreements with the FDIC that parallel those of the Industrial Bank or to agree to additional commitments and prohibitions. However, this is characterized primarily as a clarifying change that does not derogate from the FDIC’s existing powers:

Notwithstanding this deletion, the FDIC retains its general supervision, examination, and enforcement authorities . . . to take any actions beyond the scope of the Final Rule, including actions to ensure the safe and sound operation of any insured depository institution, including an Industrial Bank, and further to ensure that a parent of an Industrial Bank acts as a source of financial strength to that insured institution. For example, the FDIC may require additional, unique commitments from a Covered Company or a controlling shareholder of a Covered Company when the FDIC determines it is necessary to address specific elements of a filing or circumstances related to the filer.¹¹

⁹ *Id.* at 10,722

¹⁰ *Id.*

¹¹ *Id.* at 10,720. Note that the FDIC has already demonstrated that it will exercise this authority. *See* Square Order, at ¶ 3 (requiring Jack Dorsey to enter into a Capitalization and Liquidity Maintenance Agreement and a Parent Company Agreement as a controlling shareholder of Square Financial Services, Inc.’s (“SFSI”) parent, Square, Inc.); Nelnet Order, at ¶ 3 (same with respect to Michael S. Dunlap, as controlling shareholder of Nelnet’s parent, Nelnet, Inc.).

“Material Changes” to the Business Plan

The Final Rule maintains the prohibition on material changes to the Industrial Bank’s business plan without FDIC approval. The preamble to the Final Rule includes a list of changes that “generally have been determined to constitute a material change”:

- Increases in financial statement categories or subcategories (such as types of loans, funding, revenue, or capital) of 25 percent or more;
- Introduction of distinctly new or different business strategies or objectives, including products or services, target markets, delivery channels, or business development strategies;
- Changes to the institution’s financial strategies, or the acquisition of assets, an operating entity, or the assumption of deposits or other liabilities; or
- Changes in organizational relationships such that the manner in which the institution implements or carries out its business strategies or objectives is impacted.¹²

RETAINED FROM THE NPR

In addition to the foregoing, the Final Rule retains the following elements of the NPR. Under the Final Rule, a Covered Company must agree to certain commitments and restrictions with respect to (i) any grant of deposit insurance by the FDIC to the Industrial Bank subsidiary, and (ii) the acquisition of control of an Industrial Bank subsidiary. Although the release of the Final Rule and the approval in March of applications by SFSI and Nelnet Bank (“Nelnet”) are milestones in the FDIC’s approach to processing Industrial Bank applications, the new limitations reflected in those actions mean that applicants will continue to face significant challenges in seeking to organize or control an FDIC-insured Industrial Bank.¹³

Background

Industrial Banks are state-chartered, federally insured depository institutions subject to supervision by the FDIC and the applicable state regulator.¹⁴

¹² *Id.* at 10,722.

¹³ FDIC, *Order re: Square Fin. Servs., Inc.* (Mar. 17, 2020), <https://fdic.gov/news/news/press/2020/pr20033a.pdf> (“Square Order”); FDIC, *Order re: Nelnet Bank* (Mar. 17, 2020), <https://www.fdic.gov/news/news/press/2020/pr20034a.pdf> (“Nelnet Order”). Nelnet began operations in November. SFSI has not opened for business. *Final Rule*, 86 Fed. Reg. at 10,705 n.27.

¹⁴ All Industrial Banks in existence today are “state nonmember banks,” meaning they are

Industrial Banks chartered under state law that meet certain requirements are carved out from the definition of “bank” under the BHCA.¹⁵ As a result of the carveout, control of an Industrial Bank does not cause its controlling entity to be a bank holding company (“BHC”) under the BHCA that is subject to supervision on a consolidated basis by the Board of Governors of the Federal Reserve System (the “Board”). A controlling entity is therefore not precluded from engaging in ordinary commercial activity solely by virtue of its ownership of an Industrial Bank.

Industrial Banks generally have the same commercial and consumer lending powers as commercial banks and may offer similar services. Industrial Banks may not offer demand deposit accounts but may offer other deposit products such as savings accounts, certificates of deposit, and negotiable order of withdrawal or NOW accounts. They are subject to the Federal Deposit Insurance Act (“FDIA”), FDIC regulations, and certain provisions of the Federal Reserve Act as well as applicable law of the chartering state.¹⁶

Today, interest in Industrial Bank charters has been piqued for emergent business models and innovative technologies because of the flexibility offered by Industrial Bank structures. The industry has seen an uptick in companies, particularly financial technology (“fintech”) firms, that “engage in commercial activities or have diversified business operations . . . that would not otherwise be permissible for BHCs under the BHCA” pursuing deposit insurance for Industrial Banks.¹⁷

THE RULE

The Final Rule purports to codify the FDIC’s “existing practices” by imposing on certain companies that control or propose to control, directly or indirectly, an Industrial Bank (each, a Covered Company) certain commitments and restrictions with respect to (i) any grant of deposit insurance by the FDIC to the Industrial Bank on or after the Effective Date, and (ii) any change of

state-chartered and are not members of the Federal Reserve System. Their primary federal regulator therefore is the FDIC, though it is theoretically possible for an Industrial Bank to become a member and be subject to primary federal regulation by the Board.

¹⁵ See *supra* note 3.

¹⁶ Industrial Banks are currently chartered in California, Hawaii, Minnesota, Nevada, and Utah. *Final Rule*, 86 Fed. Reg. at 10,705 n.27. The FDIC reports having received 12 insurance applications since the beginning of 2017, of which two have been approved (*see supra* note 13), eight have been withdrawn, and two remain pending. *Final Rule*, 86 Fed. Reg. at 10,705.

¹⁷ *Final Rule*, 86 Fed. Reg. at 10,708.

control of the Industrial Bank approved by the FDIC on or after the Effective Date.¹⁸

The purpose of the Final Rule is to implement a regulatory regime applicable to Covered Companies and administered by the FDIC that is analogous to consolidated oversight of BHCs by the Board in order to reduce risk and enhance the safety and soundness of Industrial Banks, reduce risk to the deposit insurance fund (“DIF”) and ensure that Covered Companies act as a “source of financial strength” for Industrial Banks.

Scope

The Final Rule applies only to Covered Companies that are not subject to federal consolidated supervision by a banking regulator and would apply only prospectively; that is, it does not apply to a Covered Company of an Industrial Bank whose federal deposit insurance was granted before the Effective Date and over which the parent company gained control prior to the Effective Date.¹⁹ If a company acquires control of an Industrial Bank on or after the Effective Date, the Final Rule will apply, without regard to when the Industrial Bank was granted deposit insurance.

Control of an Industrial Bank may be direct or indirect for purposes of determining Covered Company status. Only business entity controllers are Covered Companies. If an Industrial Bank is controlled only by individual shareholders, the Final Rule will not apply. However, in an important change from past practice, an individual shareholder who controls a Covered Company may be required to enter a written agreement with the FDIC, as noted below. “Control” means the power, directly or indirectly, (i) to vote 25 percent or more of any class of voting shares of any Industrial Bank or any company that controls the Industrial Bank, or (ii) to direct the management or policies of any Industrial Bank or any parent company. There is a presumption of control at 10 percent direct or indirect ownership, control, or power to vote shares if (i) the Covered Company or Industrial Bank is a public company, or (ii) no other person will own, control, or hold power to vote a greater percentage.

¹⁸ This represents a slight departure from the NPR, which would have applied for insurance grants or changes of control after the Effective Date rather than on or after. The FDIC will evaluate whether to apply the Final Rule to matters pending during the period before the Effective Date “on a case-by-case basis.”

¹⁹ *Id.* at 10,714. Note, however, that the Final Rule reserves authority to require out-of-scope Covered Companies that are not subject to federal consolidated supervision by the Board to “to enter into written agreements, provide commitments, or abide by restrictions, as appropriate.” *Id.* at 10,723.

Written Agreement

Each Covered Company must enter a written agreement with the FDIC that includes the following commitments and restrictions. Per the preamble to the Final Rule, the FDIC has discretion to require an individual controller to join the agreement as a party and may in its discretion impose additional commitments and restrictions. Although this reservation of an unfettered authority to impose additional restrictions is consistent with historical FDIC practice, it undercuts the FDIC's effort to provide greater certainty to the process. In particular, Covered Companies with substantial commercial activities are at risk that this authority will be used in a way that hinders their applications.

Commitments

The Final Rule imposes a series of enterprise-wide commitments on Covered Companies intended to “provide the FDIC with more timely and more complete information about the activities, financial performance and condition, operations, prospects, and risk profile of each Covered Company and its subsidiaries and affiliates.”²⁰ Each Covered Company must:

- Provide and maintain a list of all Covered Company subsidiaries;
- Consent to FDIC examination of the Covered Company and all subsidiaries with respect to, among other things, compliance with the written agreement and “all relevant laws and regulations”;²¹
- Submit an annual report describing the Covered Company's financial condition, risk controls, information security,²² transactions between the Covered Company and its Industrial Bank and other depository institution subsidiaries and the Covered Company's compliance with applicable law (including the FDIA);
- Maintain records as the FDIC deems necessary to assess risks to the DIF;
- Submit an annual independent audit of each Industrial Bank subsidiary;
- Limit the Covered Company's representation on each Industrial Bank subsidiary's board to less than 50 percent, a new limitation that would hinder the ability of a Covered Company to manage the Industrial

²⁰ *Id.* at 10,717.

²¹ *Id.* at 10,728.

²² See the introduction to this article regarding additional reporting on information security in the Final Rule.

Bank for which it would have unfettered financial responsibility;²³

- Maintain the capital and liquidity of each Industrial Bank subsidiary at such levels as the FDIC deems appropriate and take such other actions as the FDIC deems appropriate to provide the Industrial Bank with a resource for additional capital and liquidity (e.g., pledging assets, third-party letter of credit, indemnity);
- Enter a tax allocation agreement with each Industrial Bank subsidiary designating the Covered Company to be an agent of the Industrial Bank, requiring that all tax assets be held in trust and requiring prompt remission of payments or refunds (on timing no less favorable than if the Industrial Bank were a separate taxpayer); and
- In the FDIC's discretion, each Covered Company may be required to adopt an approved "contingency plan" describing both recovery actions to be taken to address various types of stress and strategies for an orderly disposition without the need for a receiver, taking into account the "size, complexity, interdependencies, and other factors relevant to the [Industrial Bank] and Covered Company."²⁴ The intent is to provide an understanding of risk, stress, and interdependencies, and the preamble to the Final Rule distinguishes its resolution-related aspects from a formal resolution plan as follows: "[T]he contents of a contingency plan (if required) would be far less complex. A contingency plan is an explanation of the steps the Industrial Bank and Covered Company could take to mitigate the impacts of financial and operational stress outside of the receivership process."²⁵

Restrictions

The restrictions imposed by the Final Rule are generally intended to ensure that an Industrial Bank does not engage in high-risk activities and to limit the influence that a Covered Company may have on an Industrial Bank subsidiary. Without FDIC approval, an Industrial Bank controlled by a Covered Company shall not:

- Make a material change to its business plan (in a change from historical practice, this requirement is not limited to the first three years of the

²³ See the introduction to this article regarding the increase of this threshold to 50 percent in the Final Rule.

²⁴ *Final Rule*, 86 Fed. Reg. at 10,724.

²⁵ *Id.* at 10,720.

Industrial Bank's operation);²⁶

- Add or replace a director or senior executive officer for the first three years following approval of deposit insurance for an Industrial Bank or change in control of an Industrial Bank;²⁷
- Employ a senior executive officer "who is, or during the past three years has been, associated in any manner (e.g., as a director, officer, employee, agent, owner, partner or consultant) with" an affiliate;²⁸
- Enter a material contract for services (e.g., loan servicing) with the Covered Company or any subsidiary thereof.

In addition, under existing law, the FDIC "may and likely will condition approval on one or more actions or inactions of the applicant or notificant."²⁹

As the foregoing discussion indicates, reporting in some media outlets that the floodgates have been opened to Industrial Bank applications by fintech and commercial companies is significantly exaggerated. Although the Final Rule brings needed clarity to the application process for control of an FDIC-insured Industrial Bank, companies considering the advantages and disadvantages of the charter should carefully assess the impact of the Final Rule on their business plans for the Industrial Bank as well as ancillary burdens on the Covered Company itself.

²⁶ See the introduction to this article regarding examples of material changes.

²⁷ See the introduction to this article regarding approval for removal of directors or officers.

²⁸ See the introduction to this article regarding approval for affiliate interlocks and the three-year lookback.

²⁹ See 12 C.F.R. § 303.2(dd) for a list of standard conditions.