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FDIC Adopts Final Rule Regarding ILC Applications

By Bob Jaworski*

The Federal Deposit Insurance Corporation has approved a final rule that clarifies how it intends to treat applications to insure an industrial bank or industrial loan company ("ILC") or to merge with or acquire control of an ILC. The author of this article explains the final rule and its importance.

The Federal Deposit Insurance Corporation ("FDIC") has approved a final rule[1] that clarifies how it intends to treat applications to insure an industrial bank or industrial loan company (each, an "ILC") or to merge with or acquire control of an ILC. ILC charters are desirable because owning or controlling an ILC is the only way for nonfinancial services companies, which are prohibited under the federal Bank Holding Company Act ("BHCA") from owning or controlling a bank, to be able to offer banking services and products (including deposit products) to their customers.

The final rule provides that, in any case where approval of such an application will result in a nonfinancial company owning or controlling an insured ILC and thus not being subject to the BHCA or to consolidated supervision by the Federal Reserve Board ("FRB") as provided in the BHCA: (1) the approval must include certain conditions and commitments, and (2) the company and the ILC must have entered into one or more written agreements with the FDIC.

Several important questions and answers about the final rule are set forth below.

WHAT IS AN ILC?

ILCs are state-chartered depository institutions insured by the FDIC and jointly supervised by the FDIC and their chartering state's banking regulator. They may be owned by an individual, a parent bank holding company or saving and loan holding company, or a parent financial or nonfinancial firm that is

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[1] https://www.fdic.gov/news/board/2020/2020-12-15-notice-dis-b-fr.pdf.

exempt from the BHCA and therefore not subject to BHCA constraints on permissible activities or FRB consolidated supervision,[2] or they may not have a parent company.

A number of states—California, Hawaii, Minnesota, Nevada, and Utah—possess ILC chartering authority under their state banking regime, with Utah's considered the most permissive and widely used. ILCs generally offer limited deposit products, a full range of commercial and consumer loans, and other banking services. Most do not offer demand deposits, although some offer negotiable order of withdrawal ("NOW") accounts, which are not considered demand deposits.

WHAT IS THE ATTRACTION OF AN ILC CHARTER?

One of the primary attractions of an ILC charter is that, although ILCs are considered to be "banks" under the Federal Deposit Insurance Act ("FDIA"), unlike banks, they may be owned by companies that engage in nonfinancial businesses, such as manufacturing, transportation, or retail sales. Banks, on the other hand, may only be owned or controlled by a company whose activities (including the activities of any of its affiliates) are limited to those that are financial in nature or incidental to such activities.

This means, for example, that a manufacturer of automobiles or aircraft, an equipment leasing company, an internet retail shopping company or a FinTech company that provides point-of-sale hardware to merchants, cannot form or acquire an insured bank but can form or acquire an insured ILC that can engage in most of the same activities as a bank.

A separate attraction, even for financial firms, is that they can avoid consolidated supervision by the FRB. The BHCA subjects companies that own or control a bank to FRB supervision, but defines a "bank" to exclude ILCs chartered under the authority of a state law in effect or under consideration on March 5, 1987, provided:

- They do not accept demand deposits;
- They have total assets of less than $100 million; or

[2] FRB "consolidated supervision" refers to the supervision of a bank holding company and its subsidiaries by the FRB, which allows the FRB to understand "the organization's structure, activities, resources, and risks, as well as to address financial, managerial, operational, or other deficiencies before they pose a danger to the [bank holding company's] subsidiary depository institutions." *See SR Letter 08-9*, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations," Oct. 16, 2008, https://www.federalreserve.gov/boarddocs/srletters/2008/sr0809.htm.

- Another company has not acquired control over them after August 10, 1987 (the "ILC Exemption").[3]

For example, the parent company of a California-chartered ILC[4] that represents that it will not take demand deposits may obtain FDIC insurance but would not be subject to FRB consolidated supervision.

In addition, with regard to lending, since ILCs are considered to be "banks" under the FDIA, they can legally take advantage of Section 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980,[5] which amended the FDIA to permit state banks to utilize the interest rate authority available to banks in their home state when making loans to residents of other states.[6] This ability serves to greatly facilitate a national lending program.

Moreover, ILCs can take advantage of state licensing exemptions granted to banks.

Also, because ILCs are not barred from membership in the Federal Home Loan Bank ("FHLB") system, they presumably can access FHLB advances to the same extent as other depository institutions.

WHY DID IT TAKE SO LONG FOR THE FINAL RULE TO COME OUT?

The issue of what to do about ILCs has been simmering for a long time. The holdup can be attributed in large part to the fact that banks, large and small, have been united in opposition to ILCs owned by large commercial entities. Banks fear "the possibility that large commercial or technology firms will acquire industrial banks and lead to commercial and financial conglomerates with concentrated and excessive economic power."[7]

In addition, there is a widely held belief that what Congress has done—permitting states to continue to charter ILCs, allowing ILCs to obtain FDIC insurance and excluding their parent companies from FRB consolidated supervision—raises legitimate concerns about the risk posed to the Deposit Insurance Fund ("DIF") by ILCs owned by such companies.

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[3] 12 U.S. Code § 1841(c)(2)(H).

[4] The California ILC statute, Cal. Fin. Code § 18000 et seq., was enacted in 1976 and remains in effect today.

[5] Public Law 96-221.

[6] *See* 12 U.S.C. § 1831d(a).

[7] Final rule, p. 27.

ILCs have long been controversial. When Congress enacted the Garn-St. Germain Depository Institutions Act of 1982, it made all ILCs eligible for FDIC insurance.[8] Five years later, Congress passed the Competitive Equality Banking Act of 1987 ("CEBA"),[9] which, among other things, sought to close the so-called "nonbank bank" loophole in the BHCA. Before CEBA, the BHCA defined a "bank" as a company that accepts demand deposits and engages in the business of making commercial loans.

Several companies took advantage of this loophole to avoid BHCA constraints and FRB consolidated supervision by engaging in only one of those two activities. The CEBA closed this loophole by redefining a "bank" as any FDIC-insured bank or any institution that accepts demand deposits and engages in the business of making commercial loans. However, to preserve existing ILCs and the ability of states that then had laws on the books authorizing the chartering of ILCs to continue to charter new ILCs, Congress included the ILC Exemption in the CEBA.

The ILC issue came to a head in 2005 and 2006 when the FDIC received ILC filings from two very large national retailers. One filing was an application for insurance for a new ILC and the other was a change of control notice to acquire an existing ILC. Both filings generated substantial opposition from the banking industry, state banking regulators, and consumer advocacy groups.

This opposition focused largely on the perceived risk to the DIF insuring ILCs owned by companies not subject to FRB consolidated supervision. It also addressed concerns that approval would create an unlevel playing field for banks, lead to a loss of revenue and regulatory control for states, and encourage predatory lending and other harms to consumers. In the face of this opposition, both filings were ultimately withdrawn.

Various regulatory and legislative actions concerning ILCs were taken between July 2006 and March 2020 (when the FDIC published its final rule proposal), but most can perhaps be best described as "kicking the can down the road." These actions included:

1. The FDIC's imposition in July 2006 of a six-month moratorium on taking action on any filings involving ILCs owned by nonfinancial companies;
2. The FDIC's January 2007 extension of that moratorium for one year;
3. The FDIC's publication of a proposed-but-never-adopted rule in

[8] 96 Stat. 1469.

[9] Pub. L. 100-86, 101 Stat. 552 (Aug. 10, 1987).

February 2007 that concerned only ILCs owned by financial firms;

4. Enactment of the Dodd-Frank Act in 2010 that imposed a new three-year moratorium on the FDIC taking action on any ILC filings and mandated a U.S. Government Accountability Office ("GAO") study of the implications of removing all exceptions from the BHCA's definition of "bank;" and
5. Issuance of the GAO's report in January 2012.[10]

During this period several events occurred that simultaneously monopolized the attention of federal bank regulators and Congress, and lessened the urgency to deal with the ILC problem. Top among these events were the financial crisis of 2008 to 2009 and the banking crisis from 2008 to 2013, during which applications to form or acquire banks, including ILCs, declined significantly.

WHAT PROMPTED THE FDIC TO ACT NOW?

A motivating factor in the FDIC's decision to move forward with this rulemaking appears to be the recent proliferation of FinTech firms operating in the financial arena and the increasing interest these firms have expressed in possibly obtaining an ILC charter, as well as perhaps an increased interest in ILC charters generally. The FDIC notes in the preamble to the final rule:

> Recently, a number of companies have considered options for providing financial products and services by establishing an [ILC] subsidiary. Many companies have publicly noted the benefits of deposit insurance and establishing a deposit-taking institution. Although many interested parties operate business models focused on traditional community bank products and services, others operate unique business models, some of which are focused on innovative technologies and strategies, including newer business models employed by fintech firms that utilize novel or unproven products or processes.
>
> Some of the companies recently exploring an [ILC] charter engage in commercial activities or have diversified business operations and activities that would not otherwise be permissible for bank holding companies under the BHCA and applicable regulations. Given the continuing interest in the establishment of [ILCs], particularly with

[10] Dodd-Frank also directed the appropriate federal banking agency to require companies that control an insured depository institution that is not a subsidiary of a bank holding company (or savings and loan holding company) to serve as a source of strength for the institution. As indicated in this alert, the final rule includes this directive and applies it specifically to companies that control an ILC and are not subject to the BHCA.

> regard to proposed institutions that plan to implement specialty or limited purpose business models, including those focused on innovative technologies, the FDIC believes a rule is appropriate to provide necessary transparency for market participants.[11]

Backing up this statement is the fact that, since the beginning of 2017, the FDIC received 12 deposit insurance applications related to proposed ILCs,[12] whereas between 2010 through the first half of 2016, it did not receive any.[13] (Note that during 2010 to 2013, the aforementioned Dodd-Frank Act moratorium was in effect.)

WHICH ILCS ARE SUBJECT TO THE FINAL RULE?

The final rule applies only prospectively to ILCs that, on or after the effective date, become subsidiaries of companies that are not subject to consolidated FRB supervision as a result of:

- A change in control of an ILC;
- A merger transaction involving an ILC; or
- A grant of FDIC insurance to a new ILC ("Covered Companies").

The effective date of the final rule is April 1, 2021.

The final rule does not apply to grandfathered ILCs, unless and until applicability is triggered by one of the events listed above. The final rule also does not apply to ILCs that do not have a parent company or that are controlled by an individual rather than a company.

WHAT DOES THE FINAL RULE PROVIDE?

Written Agreement Between Covered Company, ILC, and FDIC

The final rule requires a Covered Company to enter into (1) one or more written agreements with both the FDIC and the subsidiary ILC that contain commitments by the Covered Company to comply with specified reporting, record-keeping and other requirements, and (2) such other written agreements, commitments or restrictions as the FDIC deems appropriate. The "other requirements" include that the Covered Company:

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[11] Final rule, p. 22.

[12] Final rule, p. 11.

[13] Appendix to Statement of Martin J. Gruenberg, FDIC Chairman, on De Novo Banks and Industrial Loan Companies before the Committee on Oversight and Government Reform; U.S. House of Representatives; 2157 Rayburn House Office Building, July 13, 2016, https://www.fdic.gov/news/speeches/spjul1316.html.

1. Consent to FDIC examination (of itself and its subsidiaries);
2. Cause each subsidiary ILC to be independently audited every year;
3. Have less than 50 percent direct or indirect representation on each subsidiary ILC Board;
4. Maintain each subsidiary ILC's capital and liquidity at levels the FDIC deems appropriate, and take such other actions as the FDIC deems appropriate to provide the subsidiary ILC with a resource for additional capital and liquidity; and
5. Execute a tax allocation agreement with each subsidiary ILC to ensure that the ILC is not prejudiced by the filing of a consolidated tax return.

In certain cases, to provide itself with a basis on which to require a Covered Company's "controlling shareholder(s)" to vote in favor of an action the FDIC might require the Covered Company to take, the FDIC may also force such shareholder(s) to join as a party to the written agreement(s).

Contingency Plan

The final rule also allows the FDIC to condition its approval or non-objection to a covered ILC filing on a commitment by the Covered Company and the ILC to adopt, maintain and implement an FDIC-approved contingency plan. The plan must set forth, at a minimum, recovery actions to address significant financial or operational stress that could threaten the ILC's safe and sound operation and one or more strategies for the orderly disposition of the ILC without the need for the appointment of a receiver or conservator.

Restrictions on ILC subsidiaries of Covered Companies

The final rule prohibits an ILC controlled by a Covered Company from:

- Making a material change in its business plan after becoming a subsidiary of the Covered Company;
- Adding or replacing a member of its board or a senior executive during the first three years after becoming a subsidiary of the Covered Company;
- Employing 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 of the ILC;
- Entering into any contract for services material to its operations (for example, a loan servicing function) with the Covered Company or any of its subsidiaries.

WHAT WILL BE THE LIKELY IMPACT OF THE RULE?

The most likely impact of the final rule is that it will spur additional ILC filings with the FDIC. Companies contemplating the formation or acquisition of an ILC (and particularly FinTech companies to which an ILC charter presents many attractions) will be able to know and assess in advance what commitments they will have to make to obtain the FDIC's approval for deposit insurance for an ILC or non-objection for a change in control of an ILC, and thereby make an informed decision as to whether or not to move forward. By contrast, pursuing such an effort pre-final rule could be likened to jumping into a pool without knowing how deep it is.

The FDIC apparently agrees that additional ILC filings are likely. It states in the preamble that it "anticipates potential continued interest in the establishment of [ILCs], particularly with regard to proposed institutions that plan to pursue a specialty or limited purpose business model."[14]

On the flip side, the final rule could spur a push, primarily by banking industry lobbyists, for federal legislation to halt or otherwise limit the proliferation of ILCs controlled by companies that are not subject to the BHCA's commercial activity constraints or to FRB consolidated supervision. Individual states and consumer advocacy groups may also join in such efforts. As indicated above, states may fear both a loss of licensing revenue (since ILCs, as "banks," are exempt from most state licensing regimes) and a loss of regulatory control over ILC activities within their borders, while consumer groups have expressed fear that use of ILCs as a vehicle through which FinTech companies can lend nationwide may enable such companies to bypass state licensing requirements and interest rate limitations.

How this all plays out over the coming months and years should be very interesting.

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[14] Final rule, p. 12.