ALERT MEMORANDUM

FDIC Finalizes Rule for Supervision of ILC Parents

December 23, 2020

On December 15, 2020, the Federal Deposit Insurance Corporation ("FDIC") finalized a rule (the "Final Rule") that codifies its approach to the supervision and regulation of parent companies of industrial loan companies and industrial banks (collectively, "ILCs") when the parent company is not subject to consolidated supervision by the Federal Reserve. The Final Rule will apply to companies that become "Covered Companies" on or after April 1, 2021. It generally will not apply to companies that already own an ILC and will not apply to companies that own ILCs but are subject to consolidated supervision by the Federal Reserve.

Historically, the FDIC has exercised indirect supervisory authority over ILC parent companies through written agreements entered into as a condition of the FDIC's approval of deposit insurance, merger, and change in control applications. The Final Rule codifies many existing FDIC practices, and is generally consistent with the March 17, 2020 proposed rule and the FDIC's conditional approvals in March 2020 of applications for deposit insurance for two *de novo* ILCs – Square Financial Services, Inc. and Nelnet Bank.[1]

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors.

NEW YORK

Hugh C. Conroy
+1 212 225 2828
hconroy@cgsh.com

WASHINGTON D.C.

Derek M. Bush
+1 202 974 1526
dbush@cgsh.com

Katherine Mooney Carroll
+1 202 974 1584
kcarroll@cgsh.com

Michael Krimminger
+1 202 974 1720
mkrimminger@cgsh.com

Allison H. Breault
+1 202 974 1532
abreault@cgsh.com

Patrick Fuller
+1 202 974 1534
pfuller@cgsh.com

Michael Sanders
+1 202 974 1894
msanders@cgsh.com

[1] For additional detail on the proposed rule ("Proposed Rule") and the conditional approvals, please see our alert memorandum dated March 26, 2020, available at https://www.clearygottlieb.com/-/media/files/alert-memos-2020/fdic-approves-two-new-ilcs-and-proposes-supervision-of-ilc-parents.pdf.

I. Background

ILCs are FDIC-insured, state-chartered depository institutions that are not members of the Federal Reserve system. The FDIC serves as their primary federal banking supervisor. While ILCs are "banks" under the Federal Deposit Insurance Act ("FDI Act"),[2] they benefit from an exemption from the definition of "bank" in the Bank Holding Company Act (the "BHC Act").[3] As a consequence, the parent companies of FDIC-insured ILCs are not subjected to supervision and regulation as bank holding companies. Among other things, this means that they are not subject to consolidated regulatory capital requirements or BHC Act activities restrictions and may engage in commercial activities.

Although ILC parents are not directly subject to FDIC regulation, the FDIC has in the past sought to impose certain prudential and supervisory requirements on parents through written agreements and commitments, such as capital and liquidity maintenance agreements. Such agreements and commitments are typically focused on protecting the safety and soundness of the ILC subsidiary, for example by ensuring the parent company provides required capital or liquidity support to the ILC, and are typically entered into by applicants as a condition of approval for deposit insurance or a change in control. The Final Rule effectively formalizes this practice.

The Proposed Rule and March 2020 conditional approvals renewed the long-running debate on competitive equality issues between ILCs and traditional banks, particularly with respect to nonfinancial commercial firms and the "mixing of banking and commerce." Commenters criticized the ILC charter and called for a new moratorium or other delays on processing ILC applications. From 2006 until the conditional approvals granted to Square and Nelnet in March 2020, the FDIC did not approve any ILC deposit insurance or change in control applications.

The FDIC stated in the preamble to the Final Rule that it has a statutory obligation to receive and process ILC applications, and "[w]hether commercial firms should continue to be able to own industrial banks is a policy decision for Congress to make." Indeed, the FDIC's stated purpose in issuing the Final Rule "is to ensure adequate oversight of industrial banks owned by financial and commercial companies."

II. Final Rule

Scope

The Final Rule applies to ILCs that become subsidiaries of "Covered Companies." A Covered Company is any company that (i) is not subject to consolidated supervision of the Board of Governors of the Federal Reserve System and (ii) controls an ILC as a result of a change in control, a merger transaction, or approval of deposit insurance on or after April 1, 2021.

The Final Rule therefore grandfathers existing ILCs and their respective parent companies, but existing ILCs may become subject to the Final Rule following a change of control, merger, or grant of deposit insurance occurring on or after April 1, 2021.

General

The Final Rule prohibits ILCs from becoming a subsidiary of a Covered Company unless the Covered Company enters into a written agreement with the FDIC and the subsidiary ILC that satisfies the requirements of the Final Rule.

When two or more Covered Companies will control an ILC, each Covered Company would be required to enter into a written agreement.

Additionally, the FDIC in its sole discretion may require that a natural person controlling shareholder join as a party to a written agreement. In such cases, the controlling shareholder would be required to cause the Covered Company to fulfill its obligations under the written agreement, whether through voting shares or otherwise.

[2] 12 U.S.C. § 1813(a)(2).

[3] 12 U.S.C. § 1841(c)(2)(H).

Under the Final Rule, an ILC controlled by a Covered Company also will need to obtain prior written FDIC approval before taking certain actions, in some cases during a three-year period following the approval and in other cases indefinitely.

Comparison to Proposed Rule

The Final Rule is largely similar to the Proposed Rule but includes a number of noteworthy changes, including:

- The annual report from a Covered Company to the FDIC, which is required as part of a written agreement under the Final Rule, now needs to describe the Covered Company's "systems for protecting the security, confidentiality, and integrity of consumer and nonpublic personal information." The preamble to the Final Rule states that this additional requirement was adopted in response to comments expressing concerns that Covered Companies and their affiliates may not be engaged in financial services and thus may not be covered by the Gramm-Leach-Bliley Act's provisions on data safeguards and privacy of customer information.
- Written agreements now must provide that a Covered Company's direct and indirect representation on the Board of Directors of a controlled ILC must represent less than 50% of directors, an increase from the Proposed Rule's limit of 25%.
- The text of the Final Rule no longer explicitly provides the FDIC sole discretion to (1) require additional commitments of a Covered Company or a controlling shareholder of a Covered Company or (2) impose additional restrictions on an ILC controlled by a Covered Company. The preamble to the Final Rule explains that this removal was to "avoid confusion that the FDIC would unilaterally impose additional commitments (or restrictions)." The preamble further notes that the FDIC retains its general supervision, examination, and enforcement authorities "to take any actions beyond the scope of the final rule," including requiring "additional, unique commitments from a Covered Company or a controlling shareholder of a Covered Company."
- The requirement that an ILC controlled by a Covered Company obtain the FDIC's prior written approval before taking certain actions would be limited to three years in the case of the following: (1) adding or replacing a member of the Board of Directors or (2) adding or replacing a senior executive officer.
- Under the Final Rule, senior executive officers previously associated in the past three years with an affiliate of an ILC controlled by a Covered Company may not be employed by the ILC without prior approval of the FDIC, which is in addition to the Proposed Rule's restriction on senior executive officers currently associated with an affiliate of the ILC.

Required Commitments in Written Agreements

The required contents of a written agreement include:

> (1) Submit to the FDIC an initial listing of all of the Covered Company's subsidiaries and update such list annually;
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> (2) Consent to the examination by the FDIC of the Covered Company and each of its subsidiaries to permit the FDIC to assess compliance with the provisions of any written agreement, commitment, or condition imposed; the FDI Act; or any other Federal law for which the FDIC has specific enforcement jurisdiction against such Covered Company or subsidiary, and all relevant laws and regulations;
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> (3) Submit to the FDIC an annual report describing the Covered Company's operations and activities, in the form and manner prescribed by the FDIC, and such other reports as may be requested by the FDIC to inform the FDIC as to the Covered Company's (i) Financial condition; (ii) Systems for identifying, measuring, monitoring, and controlling financial and operational risks; (iii) Transactions with depository institution subsidiaries of the

Covered Company; (iv) Systems for protecting the security, confidentiality, and integrity of consumer and nonpublic personal information; and (v) Compliance with applicable provisions of the FDI Act and any other law or regulation;

(4) Maintain such records as the FDIC may deem necessary to assess the risks to the subsidiary industrial bank or to the Deposit Insurance Fund;

(5) Cause an independent audit of each subsidiary industrial bank to be performed annually;

(6) Limit the Covered Company's direct and indirect representation on the board of directors or board of managers, as the case may be, of each subsidiary industrial bank to less than 50 percent of the members of such board of directors or board of managers, in the aggregate, and, in the case of a subsidiary industrial bank that is organized as a member-managed limited liability company, limit the Covered Company's direct and indirect representation as a managing member to less than 50 percent of the managing member interests of the subsidiary industrial bank, in the aggregate;

(7) Maintain the capital and liquidity of the subsidiary industrial bank at such levels as the FDIC deems appropriate, and take such other actions as the FDIC deems appropriate to provide the subsidiary industrial bank with a resource for additional capital and liquidity including, for example, pledging assets, obtaining and maintaining a letter of credit from a third-party institution acceptable to the FDIC, and providing indemnification of the subsidiary industrial bank; and

(8) Execute a tax allocation agreement with its subsidiary industrial bank that expressly states that an agency relationship exists between the Covered Company and the subsidiary industrial bank with respect to tax assets generated by such industrial bank, and that further states that all such tax assets are held in trust by the Covered Company for the benefit of the subsidiary industrial bank and will be promptly remitted to such industrial bank. The tax allocation agreement also must provide that the amount and timing of any payments or refunds to the subsidiary industrial bank by the Covered Company should be no less favorable than if the subsidiary industrial bank were a separate taxpayer.

The FDIC may also require that a Covered Company adopt a contingency plan approved by the FDIC that, among other things, sets forth recovery actions to address significant financial or operational stress that could threaten the safe and sound operation of the ILC, and strategies for the orderly disposition of the subsidiary ILC without the need for the appointment of a receiver or conservator. Such disposition could include, for example, sale of the industrial bank to, or merger with, a third party. The preamble to the Final Rule states that a contingency plan would not be a resolution plan, and the contents of a contingency plan (if required) are expected to be less complex.

Restrictions on ILC Subsidiaries

The Final Rule requires an ILC controlled by a Covered Company to obtain the FDIC's prior written approval before taking any of the following actions:

(1) Make a material change in its business plan after becoming a subsidiary of such Covered Company;

(2) Add or replace a member of the board of directors, board of managers, or a managing member, as the case may be, of the subsidiary industrial bank during the first three years after becoming a subsidiary of such Covered Company;

(3) Add or replace a senior executive officer during the first three years after becoming a subsidiary of such Covered Company;

(4) 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 of the industrial bank; or

(5) Enter into any contract for services material to the operations of the industrial bank (for example, loan servicing function) with such Covered Company or any subsidiary thereof.

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