

FDIC Approves Two New ILCs and Proposes Supervision of ILC Parents

March 26, 2020

On March 17, 2020, the Federal Deposit Insurance Corporation (“FDIC”) proposed for public comment a rule that would clarify and in some ways strengthen its regulation of parent companies of industrial loan companies and industrial banks (collectively, “ILCs”) through the FDIC’s approval authority for deposit insurance, merger, and change in control applications.¹ The following day, the FDIC approved applications for deposit insurance for two *de novo* ILCs – Square Financial Services, Inc. (“Square Bank”) and Nelnet Bank. These two developments represent significant milestones in the FDIC’s approach to ILC applications and end the FDIC’s long-running moratorium on approval of new charters, mergers, or changes in control for ILCs.

ILCs enjoy many of the same banking powers of traditional commercial banks, but ownership of an ILC does not subject a parent company to consolidated Federal Reserve Board (“FRB”) supervision and the activity limitations associated with being a bank holding company (“BHC”). 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 Proposed Rule would codify many FDIC practices applied before the moratorium, and aims to provide transparency and consistency in FDIC supervision of non-BHC parent companies of ILCs, in line with FDIC Chairman Jelena McWilliams’ stated priority of increasing transparency and opportunities for public input by relying on formal rulemakings subject to notice and comment.

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

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

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

John Lightbourne
+1 202 974 1542
jlightbourne@cgsh.com

¹ Proposed Rule: Parent Companies of Industrial Banks and Industrial Loan Companies (Mar. 17, 2020), <https://www.fdic.gov/news/news/press/2020/pr20031a.pdf> (“Proposed Rule”).
clearygottlieb.com



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 a carveout from the definition of a “bank” in the Bank Holding Company Act (“BHCA”).³ As a consequence, the parent companies of FDIC-insured ILCs are not subjected to FRB regulation and supervision as BHCs, 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 (“CALMAs”). 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 Proposed Rule would effectively formalize this practice.

The approvals of both Nelnet Bank and Square Bank bring to a close the FDIC’s long-running moratorium on new charters, mergers, or changes in control for ILCs.

Although ILCs had long been somewhat controversial, opposition strengthened dramatically following Walmart’s application to obtain deposit insurance for an ILC in 2005. Home Depot followed the next year with a change in control notice to acquire an ILC. Following public criticism, both Walmart and The Home Depot withdrew their applications.

Starting in 2006, there was a series of formal and informal moratoria on approval of ILC applications. In 2010, the Dodd-Frank Act imposed a statutory moratorium on certain ILC applications involving commercial companies. Although the Dodd-Frank moratorium expired in 2013, the FDIC did not approve any ILC applications in the intervening years until last week.

Innovations in payments in recent years have generated renewed interest in ILC charters, with nine applications filed since 2017 (some of these, including Square Bank and Nelnet Bank, were later withdrawn and refiled). Chairman Jelena McWilliams signaled in her January 2018 confirmation hearings that the FDIC might reconsider its posture on ILCs under her watch, and subsequent statements by the new Chairman that the FDIC would process ILC applications consistent with existing law led to speculation that the FDIC’s informal moratorium would be lifted.

The approval of Nelnet Bank and Square Bank will renew debate on competitive equality issues between ILCs and traditional banks. As ILCs, Square Bank and Nelnet Bank will be permitted to exercise many of the same powers as a state-chartered bank without their parent companies being subject to the limitations on activities in the Bank Holding Company Act or FRB oversight. ILCs themselves remain subject to activity limitations imposed by state law and by the FDI Act.⁴

It is noteworthy that the first two approved charters were for parent companies that are engaged in financial services, rather than non-financial commercial firms, which would have exacerbated such concerns. Concerns over potential approvals for commercial firms or virtual currency firms will undoubtedly drive much of the feedback the FDIC receives on the Proposed Rule. Notably, the

² 12 U.S.C. § 1813(a)(2).

³ 12 U.S.C. § 1841(c)(2)(H).

⁴ 12 U.S.C. § 1831a; 12 C.F.R. pt. 362.

Chairman’s statement on the Proposed Rule described these questions over “the mixing of banking and commerce” as involving “complicated policy trade-offs that are best addressed by Congress.”⁵ Rakuten, a Japanese commercial e-commerce company, announced on March 23, 2020, that it had withdrawn, but plans to refile, its pending ILC deposit insurance application.

The Proposed Rule and approvals for Square Bank and Nelnet Bank follow the FDIC’s February 7, 2020 approval of deposit insurance for Varo Bank, N.A., a purely mobile- and online-based proposed *de novo* bank.

Many aspiring fintech and other companies will likely see these developments as signaling that the FDIC may be more open to approving charters for non-traditional banking models.

Proposed Rule

Prospective Effect and Exemptions

The Proposed Rule would apply to ILCs that become subsidiaries of “Covered Companies” after the effective date of the Proposed Rule. A Covered Company is any company that (i) is not subject to consolidated FRB supervision and (ii) controls an ILC as a result of a change in control, a merger transaction, or approval of deposit insurance after the effective date of the Proposed Rule.

The Proposed Rule therefore grandfathers existing ILCs and their respective parent companies. However, though ambiguously phrased, the preamble to the Proposed Rule notes that existing ILCs may become subject to the Proposed Rule following a change of control, merger, or grant of deposit insurance occurring after the effective date.

Commitments Required in Written Agreements

The Proposed 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 content requirements of the Proposed Rule (a “Written Agreement”).

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 his or her shares or otherwise.

Commitments

The eight commitments required to be a part of a Written Agreement under the Proposed Rule are:

- (1) Submit to the FDIC an initial listing of all of the Covered Company’s subsidiaries and update such list annually;
- (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;
- (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,

⁵ Statement by FDIC Chairman Jelena McWilliams on the Proposed Rule (Mar. 17, 2020), <https://www.fdic.gov/news/news/speeches/spmar1720.html>.

- monitoring, and controlling financial and operational risks; (iii) transactions with depository institution subsidiaries of the Covered Company; and (iv) 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 or indirect representation on the board of directors or board of managers, as the case may be, of each subsidiary industrial bank to no more than 25% 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 representation as a managing member to no more than 25% 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 Proposed Rule states that the contingency plan would not be a resolution plan but instead 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.

The FDIC also would retain discretion to require additional commitments of Covered Companies and/or controlling shareholders.

In the preamble to the Proposed Rule, the FDIC asks for input on (1) whether there should be a cure period for commitments and (2) whether to include a requirement that a Covered Company maintain its own capital at a defined level.

Restrictions on ILC Subsidiaries

The Proposed Rule would also require an ILC controlled by a Covered Company to obtain the

FDIC's prior written approval before any of the following:

- (1) Making a material change in its business plan after becoming a subsidiary of such Covered Company;
- (2) Adding or replacing a member of the board of directors, board of managers, or a managing member, as the case may be, of the subsidiary industrial bank after becoming a subsidiary of such Covered Company;
- (3) Adding or replacing a senior executive officer after becoming a subsidiary of such Covered Company;
- (4) Employing a senior executive officer who is 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) Entering 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.

The FDIC would retain discretion to impose additional restrictions on the activities or operations of an ILC that is controlled by a Covered Company.

In the preamble to the Proposed Rule, the FDIC asks for input as to whether any of the foregoing restrictions should be temporally limited, such as to the first three years after becoming a subsidiary of a Covered Company.

Observations

- The Dodd-Frank Act requires that the FDIC require the parent company of an ILC that is not subject to the BHCA or Home Owners' Loan Act to serve as a "source of financial strength" for the ILC in the event the ILC

experiences financial distress.⁶ The Proposed Rule would implement this requirement by requiring a Covered Company enter into a CALMA with the FDIC. This would also align with FDIC past practice to require CALMAs with an ILC's controlling parties.

- The FDIC has described the required commitments under the Proposed Rule as consistent with requirements that it has required as a precondition for approval of ILC applications for deposit insurance in the past, including through entering into CALMAs. However, in past examples, the FDIC has in some cases been satisfied with only 50% of an ILC's board being independent members as opposed to 75% under the Proposed Rule. Additionally, the FDIC has in past examples limited the independent annual audit requirement to a set number of years after the ILC becomes a subsidiary of the parent company (for example, for three or seven years). The tax allocation requirement has also been absent from most FDIC parent company agreements ("PCAs").
- The requirements under the Proposed Rule are also generally consistent with the FDIC's 2007 notice of proposed rulemaking with respect to ILC parent companies, which was never finalized.⁷ However, significantly, the Proposed Rule does not limit ILC holding companies to "financial activities." The Proposed Rule also differs from the 2007 proposal by adding the tax allocation and contingency plan provisions.
- The Proposed Rule would also make certain obligations that would have been imposed under the FDIC's 2007 rulemaking ongoing,

⁶ 12 U.S.C. § 1831o-1(b).

⁷ Industrial Bank Subsidiaries of Financial Companies, 72 Fed. Reg. 5217 (proposed Feb. 5, 2007).

rather than expire three years after the parent company acquisition of the ILC subsidiary. In particular, the Proposed Rule would make obligations regarding performing annual independent audits of ILC subsidiaries and requesting FDIC approval for material changes in the ILC's business plan and adding or replacing members of the ILC's board of directors and senior executive management ongoing.

FDIC Approvals of Square and Nelnet ILC Deposit Insurance Applications

The FDIC's approval of Square Bank's and Nelnet Bank's ILC applications marks a watershed moment for fintech firms and signals an end to the long-running moratorium on approval of new charters, mergers, or changes in control for ILCs. The approvals, when considered with the FDIC's recent approval of Varo Bank, N.A., also signal an increasing openness by the FDIC to charter institutions that reflect a more non-traditional approach to banking. They are also likely illustrative of how the FDIC will approach ILC applications moving forward.

Nelnet Bank's application was unanimously approved by the FDIC Board of Directors. FDIC Director Martin Gruenberg voted against approving Square's application, citing his questions about Square's ability to serve as a source of strength for Square Bank.⁸

We have described the applicants, their business plans and the conditions imposed on their applications below.

Nelnet Bank

- The first ILC application conditionally approved on March 18 was Nelnet Bank, which will be a wholly-owned subsidiary of Nelnet, Inc. ("Nelnet").
- Nelnet was formed in 1978 to service federal student loans and has expanded its services to include, among other activities, education technology and payment processing.
- Nelnet first filed its application for deposit insurance with the FDIC to form Nelnet Bank in June 2018. However, Nelnet withdrew its application in September 2018 following discussions with regulators in order to enhance its application. Nelnet ultimately refiled its application in November 2019.
- Nelnet Bank would be an internet-based bank engaged in originating, refinancing and servicing private student loans and unsecured consumer loans nationwide.
- According to a statement by FDIC Chairman Jelena McWilliams, Nelnet Bank's charter would permit Nelnet "to expand its education-oriented lending and offer additional consumer credit products and deposits."⁹

Square Bank

- Square Bank was the second ILC application approved and will be a wholly-owned, and independently operated subsidiary, of Square, Inc. ("Square").
- Square was formed in 2009 as a payment services provider to enable businesses and

⁸ In addition, Director Gruenberg took issue with language included in the FDIC Board resolutions approving both Nelnet and Square that would delegate to staff the authority to modify or dispose of the conditions listed above without requiring review or approval by the FDIC Board. Director Gruenberg argued that this was contrary to a resolution reserving the authority to approve an ILC application to the FDIC Board that was adopted in 2007.

⁹ Statement by FDIC Chairman Jelena McWilliams on Nelnet Bank (Mar. 18, 2020), <https://www.fdic.gov/news/news/speeches/spmar1820a.html>.

merchants to accept card payments and has expanded its services to include point-of-sale payments and hardware, small business loans (which are offered through its subsidiary Square Capital and originated by Celtic Bank) and other financial services aimed at small businesses.

- Square first filed its application for deposit insurance with the FDIC to form Square Bank in September 2017. However, like Nelnet, Square withdrew its application in July 2018 in order to enhance certain aspects of the application. Square refiled its application in December 2018.
- In response to receiving FDIC conditional approval, Square issued a press release noting that it expected to launch Square Bank in 2021 and that Square Bank would primarily offer small business loans for Square Capital’s commercial lending business, in addition to as-of-yet undescribed deposit products.
- The press release also states that Square expects to continue to sell loans to third-party investors and limit balance sheet exposure. As a result, the release stated that Square did not expect the newly formed bank to have a material impact on its consolidated balance sheet, net revenues, gross profit or adjusted EBITDA in 2020.

Approval Orders

The FDIC conditional approvals for both Square Bank¹⁰ and Nelnet Bank¹¹ impose restrictions on their governance and activities that resemble the types of conditions generally imposed on traditional *de novo* banks (*e.g.*, capital and liquidity

requirements, notice and approval requirements for changes in ownership, the boards of directors, senior management and business plans within the first few years of operation). Some of these also mirror requirements of the Proposed Rule. The conditional orders also require Square Bank and Nelnet Bank to open for business within one year and pass a pre-opening review by the FDIC.

- Both Square Bank and Nelnet Bank would be subject to slightly higher capital requirements than a traditional *de novo* bank.
 - For instance, Nelnet Bank would be subject to a 12% leverage ratio, as compared to the 10% leverage ratio the FDIC previously imposed on the mobile-based bank Varo Bank, N.A. in February 2020.¹²
 - Square Bank would be subject to a higher 20% leverage ratio and is specifically required to maintain other capital figures above the thresholds required to be considered “well capitalized” under the FDIC’s capital rules.
 - Notably, prior ILC approvals that pre-date the FDIC’s moratoria on considering ILC applications generally did not emphasize the use of leverage ratios. However, under prior FDIC Chairman Sheila Bair, the FDIC noticeably focused more on the use of the leverage ratio. Subsequent administrations have continued this approach, and the emphasis on leverage ratios included in these ILC approvals likely reflects this trend.

¹⁰ FDIC, Square Bank Approval Order, <https://www.fdic.gov/regulations/laws/bankdecisions/depins/square-financial-services-inc-salt-lake-city-ut.pdf>.

¹¹ FDIC, Nelnet Bank Approval Order, <https://www.fdic.gov/regulations/laws/bankdecisions/depins/nelnet-bank-salt-lake-city-ut.pdf>.

¹² FDIC, Varo Bank, NA Approval Order, <https://www.fdic.gov/regulations/laws/bankdecisions/depins/varo-bank-na-drapert-utah.pdf>.

- Nonetheless, the leverage ratios for Nelnet Bank and, in particular, Square Bank are higher than most recent FDIC approvals for *de novo* institutions.¹³
- Both Nelnet and Square must also notify the FDIC of any plans to establish a loan production office at least sixty days prior to opening such facility.

Comparison of the Approval Orders and the Proposed Rule

Consistent with the Proposed Rule, each approval was conditioned on the parent company entering into CALMAs and PCAs with commitments consistent with those described in the Proposed Rule.

- Both Square and Nelnet would agree to submit to FDIC examination of the parent company and its subsidiaries, adopt a contingency plan in case the parent were unable to serve as a source of strength for the ILC subsidiary, limit the representation on the ILC's boards of directors to no more than 25%, and provide other reports as requested by the FDIC.
- Both Square and Nelnet agree to provide capital and liquidity support to the ILC. (These commitments are described in more detail below.)

Differences Between the Two Approvals and Written Agreements

While many of the conditions in the approval orders and described in Square and Nelnet's Written Agreements mirror each other, the orders and Written Agreements differ in certain respects, apparently based on differences in Square's and Nelnet's proposed business operations.

In particular, Square Bank's approval order and Written Agreement impose additional conditions and increased capital requirements, likely due to Square Bank's proposed business to originate small commercial loans to its already large, nationwide client base and the FDIC's view of the increased credit risk these small merchant borrowers pose. For instance:

- Square Bank's approval order requires it to annually submit updated business plans "for consideration by the FDIC" that include three years of pro forma financials and other relevant exhibits, prescribe capital maintenance standards relative to the bank's risk profile, and incorporate reasonable risk limits with respect to adversely classified assets, liquidity levels, and other relevant risk factors.
 - The restriction on Square Bank to not deviate from its business plan in its approval order does not include an expiration date (unlike the condition in the Nelnet Bank approval order which expires after three years).
- Square Bank's order explicitly requires Square Bank develop a comprehensive written compliance program and monitoring processes that ensures compliance with applicable consumer protection laws relevant to lending and debt collection practices.

In addition, the descriptions of Square's and Nelnet's respective Written Agreements indicate further differences in the requirements imposed on the parent companies. For instance, under the respective CALMAs and PCAs:

- Square would be required to maintain a third-party line of credit for the benefit of Square Bank and a \$50 million reserve deposit at an unaffiliated, third party insured

¹³ Aside from Varo Bank, N.A., most recent FDIC approval orders for *de novo* institutions have imposed an 8% leverage ratio.

depository institution. Conversely, Nelnet would only be required to maintain a \$40 million reserve deposit at Nelnet Bank.

- Square would also be required to purchase any loan from Square Bank at the greater of the cost basis or fair market value, if deemed necessary by the FDIC or Square Bank.
- Conversely, Nelnet would generally agree to provide sufficient capital to ensure Nelnet Bank stays above its required leverage ratio and otherwise meet its short- and long-term liquidity needs.
- Square would also be required to engage a third party to review and provide periodic reports relating to the effectiveness of Square's complaint response system and whether any material concerns are identified.

Next Steps

The Proposed Rule will no doubt be the subject of significant commentary by the banking industry, fintech companies and others interested in the possibility of obtaining an ILC charter, community groups, and members of Congress. Given FDIC Chairman McWilliams' comments on several occasions about how certain questions regarding ILC charters should be decided by Congress, there may be pressure for Congress to take some action if the FDIC is poised to begin approving a range of ILC applications.

...

CLEARY GOTTlieb