The FDIC's Proposed Rule for Industrial Banks and Industrial Loan Companies: **Five Things To Know**

On March 17, the Federal Deposit Insurance Corporation (the "FDIC") issued a notice of proposed rulemaking (the "Proposal") that would codify the FDIC's existing supervisory processes and policies that apply to industrial banks and industrial loan companies (collectively, "ILCs") and their parent companies. The FDIC announced on the following day that the FDIC Board of Directors had approved applications for deposit insurance coverage for two de novo ILCs, Square Financial Services, Inc. and Nelnet Bank.

ILCs are state-chartered, FDIC-insured depository institutions that are able to offer FDIC-insured deposit products, extend credit, and provide other banking products and services. As long as certain conditions are met, a company that controls an ILC is not subject to regulation by the Federal Reserve as a bank holding company under the Bank Holding Company Act ("BHCA"), and therefore is not subject to the activity restrictions that generally preclude a commercial company from controlling a bank. Interest in the ILC charter has been renewed in the past few years because of the growth of fintech and increasing interconnectivity between technology companies and the banking sector. The FDIC has received at least nine deposit insurance applications related to proposed ILCs over the past three years, and it is likely that the FDIC's approval of the Square Financial Services, Inc. and Nelnet Bank applications will spur even more ILC application activity. The FDIC issued the Proposal to formalize its ILC supervisory framework and to provide transparency about the framework to ILC applicants.

1 The Proposal would apply prospectively, but not to grandfathered ILCs and their parent companies.

The Proposal would only apply to an ILC that becomes a subsidiary of a "Covered Company" – a company that controls the ILC, but is not subject to supervision by the Federal Reserve under the BHCA – on or after the effective date of the final rule. The preamble to the Proposal notes, however, that grandfathered ILCs and their parent companies would remain subject to the FDIC's existing supervisory processes. Under the Proposal, a grandfathered ILC and its parent company could become subject to the Proposal as a result of a change in control or merger transaction that is consummated after the final rule's effective date.

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2 The Proposal would apply only to ILCs, but the FDIC is seeking comment on whether to extend the final rule to other non-banks under the BHCA.

The Proposal would adopt a definition of "industrial bank" that is consistent with section 2(c)(2)(H) of the BHCA, which excludes "industrial loan compani[ies], industrial bank[s], or other similar institution[s]" from the definition of "bank" for purposes of the BHCA as long as certain conditions are met. However, the preamble to the Proposal specifically requests comment on whether other exceptions to the definition of "bank" in the BHCA should be made subject to the Proposal, including credit card banks and trust banks.

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3 The Proposal would require parent companies to consent to FDIC supervision and regulation in order to acquire an ILC or to charter a de novo ILC.

The Proposal would require the Covered Company to enter into one or more written agreements (*e.g.*, a Capital and Liquidity Maintenance Agreement or Parent Company Agreement) with both the ILC and the FDIC as a condition of acquiring an ILC (including via merger) or chartering a de novo ILC. Additionally, the FDIC would retain discretion to require the controlling shareholder of a Covered Company to join such written agreements as a condition of its approval for an ILC application (as Jack Dorsey is required to do as a condition of the FDIC's approval of Square Financial Services, Inc.). The preamble to the Proposal also notes that the FDIC separately retains the authority to impose conditions in connection with such regulatory approvals and non-objections.

Through these agreements, the Proposal would require a Covered Company to make at least eight specific commitments, which are described in the Appendix to this summary. In addition, the Proposal provides that the FDIC would retain the discretion to require additional commitments from a Covered Company.

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4 The Proposal would adopt a definition of "control" that is consistent with the Change in Bank Control Act and its implementing regulations.

For purposes of determining whether an ILC parent company is a Covered Company, and whether a non-bank subsidiary of the Covered Company is an affiliate of the ILC, the Proposal would adopt a two-prong definition of control: (i) the power, directly or indirectly, to direct the management or policies of the ILC or company, and (ii) the power, directly or indirectly, to vote 25 percent or more of any class of voting securities of the ILC or company. In addition, the Proposal would incorporate by reference two presumptions of control contained in the regulations implementing the Change in Bank Control Act ("CBCA"): (i) the power to vote 10 percent or more of any class of voting securities if the ILC or company has registered securities under section 12 of the Securities Exchange Act and no other person has the power to vote a greater percentage of that class of voting securities, and (ii) the "acting in concert" presumptions in 12 C.F.R. § 303.82(b)(2).

Significantly, these CBCA control rules differ from the control rules and presumptions under the BHCA and its implementing regulations. For example, the tiered control presumptions recently adopted by the Federal Reserve under the BHCA have not been incorporated into the Proposal.

5 The Proposal would require an ILC to obtain FDIC approval before taking certain actions that may significantly impact its safety and soundness.

The Proposal would prohibit an ILC from undertaking any of the following actions without FDIC written approval, after becoming a subsidiary of a Covered Company:

1. Making a material change to the ILC's business plan.
2. Adding or replacing a member of the ILC's board of directors (or equivalent governing body).
3. Adding or replacing a senior executive officer.
4. Employing a senior executive officer who is associated with an affiliate of the ILC (*e.g.*, as an officer, director, employee, owner, etc.).
5. Entering into any contract for services material to the operations of the ILC with a Covered Company or subsidiary thereof.

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Appendix: Required Commitments of Covered Companies under the Proposal

As a condition of chartering a de novo ILC or acquiring an ILC via merger, the Proposal would require a Covered Company to enter into written agreements with the ILC and the FDIC pursuant to which the Covered Company would make the following eight commitments:

1. The Covered Company must submit a list of all of its subsidiaries to the FDIC, and update this list annually.

2. The Covered Company must consent to examination by the FDIC of the Covered Company and each of its subsidiaries.

3. The Covered Company must submit an annual report of operations and activities to the FDIC, in the form and manner prescribed by the FDIC.

4. The Covered Company must maintain records as required by the FDIC.

5. The Covered Company must cause an independent audit of each ILC subsidiary to be performed annually.

6. The Covered Company, directly or indirectly, may not have director representation on the board (or equivalent governing body) of an ILC subsidiary in excess of 25 percent of the board.

7. The Covered Company must cause each ILC subsidiary to maintain sufficient capital and liquidity as the FDIC deems appropriate, and take other action as required by the FDIC to serve as a source of strength to the ILC subsidiary.

8. The Covered Company must execute a tax allocation agreement with each ILC subsidiary providing that all tax assets are held by the Covered Company in trust on behalf of and as agent for the ILC.

In addition, the Proposal provides that the FDIC would retain the discretion to require commitments from a Covered Company beyond these eight commitments. These may include the requirement to develop a contingency plan that sets forth recovery actions to address significant financial or operational stress, and strategies for the orderly disposition of the ILC without the need for a receiver or conservator.

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