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Memorandum

FDIC Adopts Requirements for Investments in Industrial Loan Companies

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On December 15, 2020, the FDIC adopted a final rule that imposes certain information requirements and commitments on non-banking companies that acquire a controlling interest in an insured industrial bank or industrial loan company ("ILC") in connection with a deposit insurance application, change in control notice, or merger application. These commitments include providing the FDIC with ongoing financial and other reports and inspection rights, and committing to maintain the ILC's capital and liquidity at FDIC-specified levels. A "controlling interest" for these purposes is defined using the same thresholds as the FDIC's Change in Bank Control Act rules (which is, in most cases, ownership of 10% or more of the ILC's voting stock).[1]

The final rule generally codifies the FDIC's existing practices used to supervise ILCs and their parent companies, as well as certain practices adopted by the FDIC in approving two ILC deposit insurance applications in March 2020.

ILC Background

ILCs are state banks chartered in one of a handful of states (principally Utah) that have direct access to the federal safety net—including deposit insurance and the Federal Reserve's discount window and payments system—as well as virtually all of the deposit-taking, lending, and other powers of a full-service commercial bank. Despite their access to the federal safety net and broad banking powers, ILCs operate under an exception to the BHC Act which allows any type of firm, including a commercial firm or foreign bank, to acquire and operate an ILC without becoming a bank holding company under the BHC Act. Because ILC parent companies are not bank holding companies under the BHC Act, such companies are able to operate outside the framework of federal regulation and supervision of the parent holding company and engage in commercial activities that are not permitted for bank holding companies.

As a result of this flexibility in ownership structure, ILCs have historically attracted significant interest from commercial investors, as well as public and political opposition. In 2005, when Wal-Mart applied for an FDIC-insured ILC, the FDIC received more than 13,800 public comment letters regarding the proposal, with most of the comments opposed to the application. Soon after, when The Home Depot applied to acquire an ILC in 2006, the

[1] Because ILCs are "depository institutions" under the Volcker Rule, private equity and other financial investors also need to avoid having "control" of the ILC under Federal Reserve rules in order to avoid being subject to Volcker Rule restrictions on trading securities and sponsoring covered funds as an affiliate of a depository institution.

FDIC received over 800 public comment letters, almost all of which expressed opposition to the proposed acquisition. Ultimately, the Wal-Mart application and The Home Depot's notice were withdrawn.

In response to this strong public opposition, the FDIC imposed a series of moratoria, beginning in 2006, on approving deposit insurance applications and change in control notices involving industrial banks. In the 2010 Dodd-Frank Act, Congress followed suit by imposing a three-year moratorium on the FDIC's approval of deposit insurance applications for industrial banks that were owned or controlled by a commercial firm. While these moratoria have been officially lifted since 2013, no ILCs had been established for nearly twelve years prior to 2020, since June 2008.

In recent years, however, there has been renewed interest in establishing *de novo* ILCs or acquiring existing ILCs, including by potential owners that would not be subject to federal consolidated supervision and that are affiliated with organizations whose activities are primarily commercial (rather than financial) in nature. Since 2017, the FDIC has received nine deposit insurance applications related to proposed ILCs. Notably, several fintech companies have recently pursued FDIC-insured ILC charters, including payment processor Square Inc. and student loan company Nelnet Inc., which obtained approval to form FDIC-insured ILC charters in March 2020.

Scope of ILC Rule

The final rule applies to any ILC that, after the final rule's effective date of April 1, 2021, becomes a subsidiary of a "covered company," which is defined to include any company that is not subject to consolidated supervision by the Federal Reserve and that, directly or indirectly, controls an ILC as a result of a change in bank control or a merger transaction, or that is granted deposit insurance by the FDIC, in each case after the effective date of the final rule.

Importantly, "control" of an ILC is defined with reference to the FDIC's regulations implementing the Change in Bank Control Act, which define "control" to mean the power, directly or indirectly, to direct the management or policies of an ILC or to vote 25% or more of any class of voting securities of an ILC. In addition, the FDIC presumes that an acquisition of voting securities of an ILC constitutes the acquisition of the power to direct the management or policies of the ILC if, immediately after the transaction, the acquiring person will own, control, or hold with power to vote 10% or more of any class of voting securities of the ILC, and if: (i) the ILC has registered securities under Section 12 of the Securities Exchange Act of 1934; or (ii) no other person will own, control, or hold the power to vote a greater percentage of that class of voting securities immediately after the transaction. Accordingly, a company that acquires 10% or more of a class of voting securities of an ILC could be presumed to be a "covered company" subject to the final rule, if the other conditions are met.

The final rule grandfathers most currently existing ILCs, excluding from its scope any ILC that, before the final rule's effective date of April 1, 2021, is a subsidiary of a company that is not subject to consolidated supervision by the Federal Reserve. A grandfathered ILC could later become subject to the final rule, however, following a change in control, merger, or grant of deposit insurance occurring after the effective date in which the resulting institution is an ILC subsidiary of a covered company.

The final rule also does not apply to ILCs that are subsidiaries of a company that is subject to consolidated supervision by the Federal Reserve or ILCs that are not subsidiaries of a company, such as an ILC that is wholly and directly owned by one or more individuals.

Required Written Agreement

Under the final rule, an ILC will be prohibited from becoming a subsidiary of a covered company unless the covered company enters into a written agreement with the FDIC and the subsidiary ILC containing eight specified commitments and any other provisions that the FDIC deems appropriate. If two or more covered companies would control the ILC, each covered company would be required to execute such a written agreement with the FDIC and the subsidiary ILC. In addition, the FDIC would retain discretionary authority to require that a controlling individual shareholder of a covered company join as a party to any such written agreement as a condition to the approval or non-objection of an ILC filing.

The eight specifically required commitments to an ILC filing would include the following:

- **Parent Subsidiaries**: Each covered company parent must furnish to the FDIC an initial listing, with annual updates, of all of the covered company's subsidiaries;
- **FDIC Examination**: Each covered company parent must consent to the FDIC's examination of the covered company and each of its subsidiaries to monitor compliance with any written agreements, commitments, conditions, and certain provisions of law;
- **Regular Reporting**: Each covered company parent must submit to the FDIC an annual report on the covered company and its subsidiaries (including on the covered company's financial condition, risk management systems, information security and consumer privacy systems, transactions with the ILC, and compliance with other FDIC regulations), and such other reports as the FDIC may request;
- **Recordkeeping**: Each covered company parent must maintain such records as the FDIC deems necessary to assess the risks to the ILC and to the FDIC's deposit insurance fund;
- **Audit**: Each covered company parent must cause an independent audit of each subsidiary ILC to be performed annually;
- **Board Representation**: Each covered company must commit to limit its representation on the ILC's board of directors to less than 50% of the members of the board in the aggregate, with corresponding limitations for ILCs organized as LLCs;
- **Capital and Liquidity**: Each covered company must commit to maintain each subsidiary ILC's capital and liquidity at such levels as the FDIC deems necessary for the safe and sound operation of the ILC, and to take such other actions as the FDIC finds appropriate to provide each subsidiary ILC with the resources for additional capital or liquidity; and

- **Tax Allocation Agreement**: Each covered company and its subsidiary ILCs must enter into a tax allocation agreement that expressly recognizes an agency relationship between the covered company and the subsidiary ILC with respect to tax assets generated by the ILC, and that all such tax assets are held in trust by the covered company for the benefit of the ILC.

In addition to the written agreements, commitments, and restrictions specifically contained in the final rule, the FDIC noted that it may, and likely will, condition approvals or non-objection to an ILC filing on one or more actions or inactions of the applicant. Specifically, the FDIC may condition the approval of an ILC filing on the covered company and ILC committing to adopt an FDIC-approved contingency plan to address potential significant financial or operational stress and reflect strategies for the orderly disposition of the ILC without the need for the appointment of a receiver or conservator.[2]

Restrictions on ILC Subsidiaries of Covered Companies

The final rule imposes FDIC prior approval requirements for ILC subsidiaries of a covered company to take certain actions, including:

- **Business Plan**: making a material change in the ILC's business plan after becoming a subsidiary of a covered company;
- **Board of Directors**: adding or replacing a member of the ILC's board of directors or other governing body during the first three years after the ILC becoming a subsidiary of the covered company;
- **Senior Executives**: adding or replacing a senior executive officer of the ILC during the first three years after the ILC becoming a subsidiary of the covered company;
- **Affiliate Employees and Executives**: employing a senior executive officer who is, during the first three years after the ILC becomes a subsidiary of the covered company, associated in any manner with an affiliate of the ILC, such as a director, officer, employee, agent, owner, partner, or consultant of the covered company parent or any of its other subsidiaries; and
- **Affiliate Contracts**: entering into any contract for material services with the covered company parent or any of its other subsidiaries.

Approval of ILC Deposit Insurance Applications

The issuance of the final rule follows the FDIC's approval of applications for deposit insurance for Nelnet Bank and Square Financial Services, Inc. FDIC Chairman Jelena McWilliams stated in connection with the adoption of the final rule that the rule is intended to "provide transparency to market participants regarding the FDIC's minimum expectations for parent companies of industrial banks." While Chair McWilliams previously stated that the outcome of FDIC votes on ILC charter applications "should not be interpreted as an endorsement, or a

[2] In adopting the final rule, the FDIC noted that any such a contingency plan would be "meaningfully different" from (and "far less complex" than) resolution plan requirements for large banks.

criticism, of the industrial bank charter," she noted that "the FDIC has a responsibility to consider such applications and, if such an application satisfies the statutory factors, approve such an application, no different than any other type of application." It remains to be seen whether and when the composition of the FDIC Board of Directors will change during the incoming Biden Administration and what attitude those new Board members may have toward considering and approving the chartering and acquisition of ILCs.

For more information regarding industrial bank charters, please contact any member of the Firm's Financial Institutions Group, including those listed below.

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