FDIC Proposes Supervision of ILC Holding Companies

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The FDIC proposed a rule to formalize certain longstanding expectations it has for approving applications by new industrial loan companies (ILCs) that would be subsidiaries of a parent company that would not be subject to consolidated supervision by the Federal Reserve. The proposal would require a written agreement with the ILC parent and prior FDIC approval for certain changes at the ILC level and allow the FDIC to impose other requirements. The FDIC characterized the proposal as "formalizing and strengthening [its] existing supervisory processes and policies." The proposal should be of interest to fintechs and other nontraditional firms seeking to enter the banking sector without becoming a bank holding company.

Scope

- The **proposal** would apply to any ILC that, after the effective date of the rule, becomes a subsidiary of a **Covered Company**.[1]
  - The proposal defines an ILC as an insured State bank that is an industrial bank, industrial loan company or other similar institution that is excluded from the definition of bank under the Bank Holding Company Act.
  - The FDIC requests comment on whether the proposal should apply to other institutions that are similarly excluded from the definition of bank under the Bank Holding Company Act (e.g., **limited-purpose credit card banks and trust banks**).
- The proposal would not apply to:
  - an ILC that, as of the effective date of the rule, is a subsidiary of a company that is not subject to consolidated supervision by the Federal Reserve, although such an ILC could become subject to the rule after its effective date following a change in control, merger or grant of deposit insurance (this category captures most existing ILCs);
  - an ILC that is a subsidiary of a company that is subject to consolidated supervision by the Federal Reserve; or
  - an ILC that is not a subsidiary of a company, such as an ILC that is wholly and directly owned by one or more individuals.

[1] Covered Company means 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 pursuant to section 7(j) of the Federal Deposit Insurance Act (**FDIA**) or a merger transaction pursuant to section 18(c) of the FDIA, or that is granted deposit insurance by the FDIC pursuant to section 6 of the FDIA, in each case after the effective date of the rule. The definition of control for this purpose is consistent with the Change in Bank Control Act and the FDIC implementing regulations.

- The FDIC asks whether an individual that controls the parent company of an ILC should be responsible for the maintenance of the ILC's capital and liquidity at levels specified by the FDIC, or for causing the parent company to comply with the written agreements, commitments, and restrictions imposed on the ILC.

Written Agreement Requirement

- The proposal would prohibit an ILC 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 such other written agreements, commitments or restrictions as the FDIC deems appropriate, including, but not limited to, a contingency plan.
  - If multiple Covered Companies control the ILC, each Covered Company would be required to execute a written agreement.
  - The FDIC would also have sole discretion to condition its grant of deposit insurance, issuance of a non-objection to a change in control, or approval of a merger on an individual who is a controlling shareholder of a Covered Company joining as a party to any written agreement required under the proposal.
    - The FDIC stated in the preamble that, in such cases, the individual controlling shareholder "would be required to cause the Covered Company to fulfill its obligations under the written agreement, through voting his or her shares, or otherwise."
- The eight commitments require the Covered Company to:
  (1) Submit to the FDIC an initial **listing of all of the Covered Company's subsidiaries** and update that 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 FDIA or any other federal law for which the FDIC has specific enforcement jurisdiction against the 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 as to the Covered Company's:
    - financial condition;
    - systems for identifying, measuring, monitoring, and controlling financial and operational risks;
    - transactions with depository institution subsidiaries of the Covered Company; and
    - compliance with applicable provisions of the FDIA and any other law or regulation.

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

  (5) Cause an **independent audit** of each subsidiary ILC to be performed annually;

  (6) Limit the Covered Company's direct or indirect **representation on the board of directors** of the subsidiary ILC to **no more than 25%** of the members of the board in the aggregate, with corresponding limitations for ILCs organized as LLCs;

(7) Maintain the **capital and liquidity** of the subsidiary ILC at such levels as 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 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 ILC;[2] and

(8) Execute a **tax allocation agreement**[3] with its subsidiary ILC that expressly states that an agency relationship exists 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 subsidiary ILC and will be promptly remitted to the ILC. The tax allocation agreement also must provide that the amount and timing of any payments or refunds to the subsidiary ILC by the Covered Company should be no less favorable than if the subsidiary ILC were a separate taxpayer.

- The FDIC would also have the option to require a Covered Company and subsidiary ILC to commit to provide to the FDIC and, thereafter, implement and adhere to a **contingency plan** subject to the FDIC's approval.
  - The contingency plan would, at a minimum, have to contain recovery actions to address significant financial or operational stress that could threaten the safe and sound operation of the ILC and one or more strategies for the orderly disposition of the ILC without the need for the appointment of a receiver or conservator.
  - The FDIC emphasized in the preamble its discretion to tailor the required contents of any such contingency plan and that the contingency plan would not be a resolution plan.

Restrictions on ILC Subsidiaries of Covered Companies

- The proposal would require an ILC controlled by a Covered Company to obtain the FDIC's prior written approval before:

(1) **Materially changing its business plan** after becoming a subsidiary of such Covered Company;

(2) **Adding or replacing a member of the board of directors** (or equivalent governing body) of the subsidiary ILC 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 ILC; or

(5) **Entering into any contract for services material to the operations of the ILC** (for example, loan servicing function) **with such Covered Company** or any of its subsidiaries.

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[2] This provision is consistent with the source of financial strength requirement set forth in section 38A of the FDIA, 12 U.S.C. § 1831o-1(b).

[3] See also our **Davis Polk client memorandum** on a recent Supreme Court decision relating to tax allocation agreements.

- The FDIC requests comment on whether any of these restrictions should be time-limited, for example, to the first three years after an ILC becomes a subsidiary of a Covered Company.

No Moratorium on Applications Under the Current Framework

- In her statement on the proposal, FDIC Chairman Jelena McWilliams rejected calls for a moratorium on grants of deposit insurance to ILCs by announcing that the FDIC would consider applications for deposit insurance from two ILCs later that day. The next day, the FDIC announced its approval of applications for deposit insurance for **Nelnet Bank** and **Square Financial Services, Inc.** FDIC Board Member Martin Gruenberg voted **in favor of** approval of the Nelnet application but **against** approval of the Square application.
  - Chairman McWilliams stated in connection with the proposal, "[T]he 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. The outcome of the vote on these applications should not be interpreted as an endorsement, or a criticism, of the industrial bank charter, but rather the fulfillment of a statutory responsibility to consider such applications."

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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