FDIC Issues Final Rule on Supervision of ILC Holding Companies

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The FDIC has issued a final rule to formalize longstanding expectations it has had for the parent company of a new industrial loan company (ILC). The FDIC adopted the proposed rule issued in March 2020 with few changes. The final rule requires a new ILC to enter into a written agreement with the ILC parent and the FDIC, and requires prior FDIC approval for certain changes at the ILC level. Fintechs and other nontraditional firms seeking to enter the banking sector without becoming a bank holding company may be especially interested in the final rule. The final rule has attracted criticism and calls for Congress to eliminate ILCs.

Scope

- The **final rule** would apply to any ILC that, on or after the effective date of April 1, 2021, becomes a subsidiary of a **Covered Company**.[1]
  - The final rule 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 final rule would not apply to:
  - an ILC that, before April 1, 2021, 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 on or 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.
- The final rule has three key changes compared to the proposed rule:
  - A Covered Company's permitted representation on the board of a subsidiary ILC was increased from 25% or less to **less than 50%**;

[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 on or 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 restrictions on the appointment of directors and senior executive officers of the ILC apply to the ILC only during the **first three years after becoming a subsidiary** of a Covered Company; and
- Covered Companies must prepare **additional reporting** regarding systems for protecting the security, confidentiality, and integrity of consumer and nonpublic personal information.

Written Agreement Requirement

- The final rule prohibits 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 commitments specified in the final rule 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 is required to execute a written agreement.
  - The FDIC has 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 required written agreement.
    - An individual who controls the parent company of an ILC would not be responsible for maintenance of the ILC's capital and liquidity, but may be asked by the FDIC to join as a party to the written agreements with the FDIC and therefore would be required to vote his or her shares or take appropriate action to cause the Covered Company to fulfill its obligations under the written agreements.
- 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;
    - systems for protecting the security, confidentiality and integrity of consumer and nonpublic personal information; 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 and indirect **representation on the board of directors** of the subsidiary ILC to **less than 50%** 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 has 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 must 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 restated in the preamble its discretion to tailor the required contents of any such contingency plan.

Restrictions on ILC Subsidiaries of Covered Companies

- The final rule requires 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 during the first three years after becoming a subsidiary of such Covered Company;

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

(4) **Employing 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 ILC; or

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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.

(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.

Continued Consideration of Applications Before Effective Date

- The preamble to the final rule notes that the FDIC will consider pending deposit insurance applications, change in control notices and merger applications for ILCs on a case-by-case basis during the period before April 1, 2021.
  - The preamble adds that, in any such case, the FDIC would impose conditions and requirements as appropriate and as consistent with current practice and the FDIC's general examination, supervision and enforcement authorities.
  - The final rule has attracted criticism for easing the ability to create an ILC and has led to calls for Congress to eliminate ILCs.

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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