

December 10, 2020

MEMORANDUM TO: The Board of Directors

FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision

SUBJECT: Final Rule
Parent Companies of Industrial Banks and Industrial Loan
Companies

Recommendation

Staff recommends that the Board of Directors (Board) adopt the attached final rule and authorize its publication in the Federal Register. The final rule would establish Part 354 of the FDIC Rules and Regulations (Part 354), which requires certain conditions and commitments for each deposit insurance application approval, non-objection to a change in control notice, and merger application approval that would result in an insured industrial bank or industrial loan company (industrial bank) becoming, on or after the effective date of the final rule, a subsidiary of a company that is not subject to consolidated supervision by the Federal Reserve Board (Covered Company). The final rule would require that before any industrial bank may become a subsidiary of a Covered Company, the Covered Company must enter into one or more written agreements with the FDIC that contain certain commitments to be undertaken by the Covered Company to ensure the safe and sound operation of such industrial bank. The final rule also requires the FDIC's prior approval before an industrial bank that is a subsidiary of a Covered Company may take certain actions. The final rule promotes transparency, clarity, and the sound regulation of industrial bank subsidiaries, as well as oversight of certain parent companies of industrial banks.

Concur:

Nicholas Podsiadly
General Counsel

Background

Section 2(c) of the Bank Holding Company Act (BHCA) provides certain exceptions to the definition of “bank” that allow a company to own or control an industrial bank without becoming a bank holding company (BHC) under the BHCA. The exceptions allow both financial and commercial companies to own and control industrial banks. Congress expressly adopted the exceptions as part of the Competitive Equality Banking Act of 1987 (CEBA).¹ As a result, parent companies of industrial banks are not subject to the BHCA’s activities restrictions or FRB supervision and regulation.²

As of September 30, 2020, there were 23 industrial banks³ with \$173 billion in aggregate total assets. Four industrial banks reported total assets of \$10 billion or more; ten industrial banks reported total assets of \$1 billion or more but less than \$10 billion. A significant number of the industrial banks support the commercial or specialty finance operations of their parent company and are funded through non-core sources. Generally, the industrial banks offer limited deposit products, a full range of commercial and consumer loans, and other banking services.

Since the beginning of 2017, the FDIC has received twelve Federal deposit insurance applications related to proposed industrial banks.⁴ These filings have proposed non-traditional business models, and ownership and control structures that would not be subject to Federal consolidated supervision. The FDIC anticipates continued interest in the establishment of industrial banks, particularly with regard to proposed institutions that plan to pursue a specialty or limited purpose business model.

Statutory Authority

The FDIC has authority to issue rules to carry out the provisions of the FDI Act,⁵ including rules to ensure the safety and soundness of industrial banks and to protect the Deposit Insurance Fund (DIF). As deposit insurer, the FDIC has been provided unique authority as the only banking agency with the power to grant deposit insurance to a proposed institution, or terminate deposit insurance in the case of an existing insured institution.

¹ Pub. L. 100-86, 101 Stat. 552 (Aug. 10, 1987).

² The CEBA created explicit exemptions from the definition of “bank” that remain in effect today for certain categories of federally insured institutions including industrial banks, credit card banks, and limited purpose trust companies. To be eligible for the CEBA exemption from the BHCA definition of “bank” an industrial bank must have received a charter from one of the States eligible to issue industrial bank charters, and the law of the chartering state must have required Federal deposit insurance as of March 5, 1987. In addition, an industrial bank must meet one of the following criteria: (1) not accept demand deposits, (2) have total assets of less than \$100 million, or (3) have been acquired prior to August 10, 1987.

³ Of the 23 industrial banks existing as of September 30, 2020, 14 were chartered in Utah, four in Nevada, three in California, one in Hawaii, and one in Minnesota. Under the CEBA, these states were permitted to grandfather existing industrial banks and charter new industrial banks. Colorado was also grandfathered, but it has no active industrial banks and has since repealed its industrial bank statute. An additional industrial bank, Nelnet Bank, Salt Lake City, Utah (Nelnet Bank), began operations in November of 2020.

⁴ Of the twelve deposit insurance applications, two were approved, eight were withdrawn, and two remain pending.

⁵ See FDI Act §§ 9(a) and 10(g), 12 U.S.C. 1819(a)(Tenth) and 1820(g).

In granting deposit insurance for any insured depository institution, including an industrial bank, the FDIC must assess the safety and soundness of the proposed institution, and the risk posed to the DIF. The FDIC may also approve or deny a merger application, or issue a non-objection or an objection to a change in bank control notice, by a state nonmember bank based, in part, on evaluating safety and soundness and risk to the DIF.⁶ In addition, as it relates to industrial banks that would be subject to the final rule, the FDIC requires that Covered Companies serve as a source of financial strength for the industrial bank.⁷

Consistent with this authority and the FDIC’s mission, its role as deposit insurer, and as the appropriate Federal banking agency for industrial banks,⁸ the FDIC possesses the necessary authority to adopt Part 354. Further, the appropriateness of adopting the final rule is supported by the risks identified in recent filings, including those regarding ownership and control structures, affiliate relationships, and business models. The provisions of the final rule will enhance the FDIC’s supervisory processes and practices during a variety of economic cycles, and contribute to protecting the DIF.

Need for the Rulemaking and the Proposed Rule

On March 31, 2020, the FDIC published a notice of proposed rulemaking (NPR) to establish Part 354. The purpose of the rulemaking was to codify existing practices utilized by the FDIC to supervise industrial banks and their parent companies, mitigate undue risk to the DIF that may otherwise be presented in the absence of Federal consolidated supervision, and ensure that the parent company that owns or controls an industrial bank serves as a source of financial strength for the industrial bank, consistent with section 38A of the FDI Act.⁹ In addition to providing this comprehensive framework for supervision, the proposal would also provide interested parties with clarity and transparency regarding the FDIC’s practices when making determinations on certain filings involving industrial banks.

The proposed rule would have required certain conditions and commitments for each deposit insurance application approval, non-objection to a change in control notice, and merger application approval that would result in an industrial bank becoming a subsidiary of a Covered Company. The proposal would have required each such Covered Company, and as appropriate, the controlling shareholder(s), to enter into one or more written agreements with the FDIC and the industrial bank subsidiary. The table below describes each of the eight proposed commitments.

NPR Citation	Commitments
354.4 (a)(1)	Covered Company List of Subsidiaries. Furnish an initial listing, with annual updates, of all Covered Company subsidiaries to provide timely and appropriate information about the activities, financial performance and

⁶ See FDI Act §§ 5, 6, and 8, 12 U.S.C. 1815, 1816, and 1818.

⁷ See 12 U.S.C. 1831o-1.

⁸ See 12 U.S.C. 1813(q). Industrial banks may become members of the Federal Reserve System, but typically do not, so they are state nonmember banks, for which the appropriate federal banking agency is the FDIC.

⁹ 12 U.S.C. 1831o-1(b).

	condition, operations, prospects, and risk profile of the Covered Company and its subsidiaries.
354.4 (a)(2)	Consent to Examination. Consent to FDIC examination of the Covered Company and each subsidiary to monitor compliance with relevant laws and regulations.
354.4 (a)(3)	Annual Report. Submit an annual report on the Covered Company and its subsidiaries, and such other reports as the FDIC may request to monitor: (i) financial condition; (ii) systems for identifying, measuring, monitoring, and controlling financial and operational risks; (iii) transactions with insured subsidiaries; and (iv) compliance with the FDI Act and any other law or regulation.*
354.4 (a)(4)	Additional Records. Maintain such records as the FDIC deems necessary to assess risks to the industrial bank and the DIF.
354.4 (a)(5)	Independent Annual Audit. Cause an annual independent audit of each industrial bank to be performed.
354.4 (a)(6)	Limit Covered Company Representation on Bank Board of Directors. Limit representation on the industrial bank's board of directors to 25 percent of the members (or equivalent, depending on corporate structure) to address the Covered Company's influence over the subsidiary industrial bank.**
354.4 (a)(7)	Capital and Liquidity Levels. Maintain the industrial bank's capital and liquidity at such levels as the FDIC deems necessary for the safe and sound operation of the industrial bank, and to take other actions as appropriate to provide the industrial bank with the resources for additional capital or liquidity.
354.4 (a)(8)	Tax Allocation Agreement. Enter into a tax allocation agreement with the industrial bank, acceptable to the FDIC. A 1998 interagency policy statement, as amended in 2014, ¹⁰ addresses tax allocation. The proposal similarly sought to avoid potential harm to the industrial bank subsidiary by requiring a written tax allocation agreement.

*Staff proposes to expand this commitment in the final rule to address the protection of consumer and non-public personal information. Please see the table on page 9 of this memorandum.

**Staff proposes to change this commitment in the final rule to increase the limit to less than 50 percent. Please see the table on page 9 of this memorandum.

The proposal also included in section 354.4(b) the FDIC's authority to require, as an additional commitment, a contingency plan that, among other items, set forth the strategies for the orderly disposition of the industrial bank should the institution become troubled and ultimately fail. Section 354.4(c) also provided the FDIC with the ability, in its sole discretion, to require any other commitments.¹¹

¹⁰ See Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure, 63 FR 64757 (November 23, 1998); Addendum to the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure, 79 FR 35228 (June 19, 2014).

¹¹ In response to commenters concerns about the application of this section as well as section 354.5(b), staff proposes deletion of sections 354.4(c) and 354.5(b). Please see the table on page 9 of this memorandum.

In addition to the required written agreements, the FDIC would continue to include appropriate conditions in any approval or non-objection. Such conditions may include standard conditions provided in section 303.2 of the FDIC Rules and Regulations, as well as any other conditions deemed appropriate under the facts and circumstances.¹²

The restrictions included in the proposal would have required the FDIC’s prior written approval before an industrial bank subsidiary of a Covered Company may take certain actions to provide the safeguards and protections the FDIC believes are prudent to maintain the safety and soundness of the industrial bank subsidiary.

NPR Citation	Action	Support for Prior Approval
354.5(a)(1)	Material change in business plan.	To ensure the industrial bank operates within the business plan on which approval of deposit insurance was granted.
354.5(a)(2)	Add or replace a member of the board (or equivalent).*	To address the degree of influence by the Covered Company over the subsidiary industrial bank.
354.5(a)(3)	Add or replace a senior executive officer.*	
354.5(a)(4)	Employ a senior executive officer who is associated in any manner with an affiliate.**	
354.5(5)	Enter into any contract for material services with the Covered Company or a subsidiary thereof.	

**Staff proposes to limit this restriction to the three-year period after an industrial bank becomes a subsidiary of a Covered Company. Please see the table on page 9 of this memorandum.*

***Staff proposes to modify this restriction to apply to a proposed senior executive officer who is or was during the past three years associated with an affiliate of the industrial bank. Please see the table on page 9 of this memorandum.*

Under section 354.5(b), the FDIC could impose, on a case-by-case basis, additional restrictions on an industrial bank’s activities or operations if circumstances warrant.¹³ In addition, the proposal included a reservation of authority to clarify that the FDIC retains the authority to take appropriate supervisory and enforcement actions, including actions to address unsafe or unsound practices, or violations of law. Thus, the FDIC would retain authority to require any industrial bank and its parent company, if not otherwise subject to Part 354, to enter into written agreements, provide commitments, or abide by restrictions, as appropriate, to maintain the safety and soundness of the industrial bank and mitigate risk to the DIF.

¹² See 12 CFR 303.11(a). (The FDIC may approve, conditionally approve, deny, or not object to a filing after appropriate review and consideration of the record.) See 12 CFR 303.2(d) for a list of standard conditions.

¹³ See *supra* note 11.

Summary of Comments

The comment period for the NPR ended on July 1, 2020, after an extension from the original June 1, 2020, closing date. The FDIC received 29 comment letters from a variety of individuals and entities, including insured depository institutions, industry groups, consumer and public interest groups, state banking regulators, law firms, and academics, as well as a member of Congress.

Many commenters were generally supportive of the FDIC's efforts to clarify the supervisory framework for the parent companies and affiliates of industrial banks, providing transparency to current and prospective regulated entities. Commenters supportive of the industrial bank charter cited the benefits of charter choice and increased competition in the provision of financial services. These commenters also asserted that the existing joint State regulator-FDIC supervisory approach to supervising industrial banks has been effective, and that industrial banks do not present an increased safety and soundness risk.

Bank trade associations, consumer groups, and academics were generally critical of the proposed rule. They raised affiliation, competitive, consumer protection, and other concerns primarily focused on non-financial firms' ownership of industrial banks. They also expressed concerns about the FDIC's ability to supervise industrial banks and their parent companies, and the FDIC's justification for the proposed rule in light of administrative law requirements. The preamble to the final rule addresses these comments in detail, and some of the key themes that emerged are summarized below.

Separation of Commerce and Banking

Several commenters asserted that commercial ownership of an industrial bank goes against the policy of separating banking and commerce. These commenters argued that allowing commercial firms and banks to combine could potentially lead to conflicts of interest in the lending process and undue concentrations of economic power, concerns they contend underlie the general prohibition against the mixing of banking and commerce in the BHCA. However, Congress explicitly exempted industrial banks from the BHCA's restrictions on commercial affiliations when it enacted the CEBA. The continuing ability of commercial firms to own industrial banks is a policy decision for Congress to make. The FDIC's responsibility is to implement the law as it exists today.

Certain commenters argued that a moratorium, or a delay in the rulemaking more generally, was important in light of the current economic stress and uncertainty caused by the COVID-19 pandemic. In the last three years, the FDIC has seen an increase in the number of industrial bank filings. Accordingly, the FDIC is taking appropriate action through this final rule to ensure the sound regulation of industrial bank subsidiaries and their parent companies, while improving transparency and clarity to interested parties as it complies with the obligation to give each industrial bank filing due consideration.

Commenters' concerns about conflicts of interest are addressed by sections 23A and 23B of the Federal Reserve Act, which quantitatively and qualitatively limit transactions between a

bank and its affiliates.¹⁴ Section 23B of the Federal Reserve Act requires that any transaction between a bank and its affiliates needs to be “on terms and conditions, including credit standards, that are substantially the same, or at least as favorable to [the bank] as those prevailing at the time for comparable transactions with unaffiliated companies.”¹⁵ All covered transactions between a bank and its affiliates must be on terms and conditions that are consistent with safe and sound banking practices.¹⁶ Enforcing these restrictions is an important focus of the FDIC’s examination and supervision program to mitigate the risks to insured depository institutions from affiliates.

As for commenters concerns about the threat that large commercial and financial combinations may pose to competition, the FDIC recognizes that emerging technologies and other trends are leading to changes in the provision of banking services. Recognizing that the business models proposed by industrial banks are evolving, the FDIC is issuing Part 354 in order to ensure that the market for the provision of banking services remains competitive and safe and sound.¹⁷

Lack of Federal Consolidated Supervision

Several commenters also argued that commercial ownership of an industrial bank raises risk to the DIF given the lack of Federal consolidated supervision over the commercial parent company. Those commenters were critical of the FDIC’s proposed rule as failing to achieve parity with the consolidated supervision required for BHCs. They cited as examples the absence of consolidated capital and liquidity standards for Covered Companies and affiliates, as well as data safeguards and consumer privacy requirements stemming from the Gramm-Leach-Bliley Act of 1999 (GLBA).

The FDIC has the authority to effectively regulate industrial banks and their parent companies, and the final rule will strengthen the FDIC’s supervision. In addition to the prudential considerations applied during its review of applications for deposit insurance or mergers, and notices of change in control, the FDIC has historically required capital and liquidity maintenance agreements and other written agreements between the FDIC and parties in control of industrial banks, which are enforceable under the FDI Act.¹⁸

The FDIC also has the authority under Section 38A of the FDI Act to require a company controlling an industrial bank to serve as a source of financial strength to that institution,¹⁹ and to require reporting from the controlling company to ensure it can fulfill this obligation.²⁰ The FDIC’s supervisory authorities apply to a parent company or bank affiliate whose activities

¹⁴ 12 U.S.C. 371c(a)(2).

¹⁵ 12 U.S.C. 371c(b).

¹⁶ 12 U.S.C. 371c(a)(4).

¹⁷ The Bank Merger Act and the Change in Bank Control Act require the FDIC to consider anticompetitive effects of a transaction when evaluating those transactions. Additionally, the FDIC’s review of applications for deposit insurance for industrial banks may consider the competitive effects in regards to the risk posed to the DIF and whether the application serves the convenience and needs of the community to be served.

¹⁸ FDI Act §§ 8 and 50, 12 U.S.C. 1818 and 1831aa.

¹⁹ FDI Act § 38A(a) and (d), 12 U.S.C. 1831o-1(a) and (d).

²⁰ See FDI Act § 38A(d), 12 U.S.C. 1831o-1(d).

impact the bank, which gives the FDIC the power to protect an industrial bank from risks posed by affiliates.²¹ The final rule also includes an optional contingency plan requirement that the FDIC may impose depending on the filer's business plan and other factors, which further mitigates risk to the DIF.

Impact on Consumers

Consumer advocates raised concerns that the growth of industrial banks creates risks for consumers, as there is an opportunity for non-financial parent companies of industrial banks to gather sensitive consumer data. The FDIC will continue to supervise and examine industrial banks and enforce compliance with the GLBA and all other federal consumer protection laws and regulations. In response to the concerns raised by commenters that Covered Companies are not subject to the GLBA, the final rule contains a requirement that Covered Companies inform the FDIC about systems for protecting the security, confidentiality, and integrity of consumer and customer nonpublic personal information as part of the Covered Company's commitment to submit an annual report to the FDIC. This will provide the FDIC with appropriate information related to the Covered Company's potential consumer protection risks.

Administrative Law Concerns

Several commenters argued that the FDIC offered insufficient justification for the proposed rule. In the NPR, the FDIC complied with Administrative Procedure Act (APA) requirements to provide adequate detail and rationale for the proposed rule to permit meaningful comment by interested parties.²² The NPR provided significant discussion of the factual, legal, and policy considerations for the proposed rule, including an acknowledgement and discussion of arguments raised by critics in prior review and rulemaking contexts. The variety of comments submitted by interested parties on a number of issues demonstrates the robustness of these discussions in the proposed rule.

A few commenters argued that the NPR did not adequately discuss the FDIC's decision to allow industrial bank applications in the wake of both the temporary moratorium the FDIC put into place from 2006 to 2008 and the subsequent 2010 to 2013 moratorium Congress enacted through the Dodd-Frank Act. These commenters suggested that it is arbitrary and capricious, and violates the APA, to change policy (since the ILC moratorium) without further explanation. However, it is well-settled law that an agency is entitled to make a change of course in policy so long as the change is statutorily permissible and a reasoned explanation is provided.²³ The notice of proposed rulemaking provided a reasoned discussion of the FDIC's decision to move forward with the proposed rule now, when it chose not to do so with the 2007 rulemaking. Many factors informed FDIC's decision not to advance the 2007 rulemaking. For instance, industry conditions and other factors had the effect of reducing organizer interest in establishing new ILCs.

²¹ See FDI Act § 10(b) and (b)(4)(A), 12 U.S.C. 1820(b) and 1820(b)(4)(A).

²² 5 U.S.C. 553(b); see, e.g., *National Lifeline Association v. F.C.C.*, 921 F.3d 1105, 1115 (D.C. Cir. 2019).

²³ See, e.g., *Encino Motorcars, LLC v. Navarro*, 136 S.Ct. 2117, 2126 (2016); *F.C.C. v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009); *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

Final Rule

After careful consideration of the comments received, staff recommends that the Board adopt the final rule largely as proposed. Staff proposes the following changes to the proposed rule:

FR Citation	
354.1(b)	Clarifying revision that requires compliance from covered entities on or after the effective date of the rule rather than simply after, as proposed.
354.4 (a)(3)(iv)	Annual Report (commitment). Adds a requirement for the Covered Company to inform the FDIC about its systems for protecting the security, confidentiality, and integrity of consumer and nonpublic personal information. This reporting will provide the FDIC appropriate information related to the Covered Company’s potential consumer protection risks.
354.4 (a)(6)	Limit Covered Company Representation on Bank Board of Directors (commitment). The limitation for representation on the industrial bank’s board of directors has been raised in the final rule from 25 percent, as proposed, to less than 50 percent. This change enables Covered Companies and industrial banks to exercise additional flexibility when selecting directors.
354.5(a)(2) 345.5 (a)(3)	Add or replace a member of the board (or equivalent) or senior executive officer (restrictions). The duration of these restrictions will be limited to the three-year period after the industrial bank becomes a subsidiary of a Covered Company. This change enables Covered Companies and industrial banks to exercise additional flexibility following the three-year period to more timely appoint directors and senior executive officers.
354.5(a)(4)	Employ a senior executive officer (restriction). Because of the changes made to paragraphs (a)(2) and (a)(3) described above, this restriction is being modified to cover a senior executive officer who is or <i>was during the past three years associated with an affiliate of the industrial bank</i> . The change prevents, without the FDIC’s prior written approval, the employment of a senior executive officer following a brief break in the senior executive officer’s employment with an industrial bank affiliate. The duration remains perpetual as proposed.
354.4(c) 354.5(b)	Additional commitments and restrictions. In response to commenters concerns about the possibility of unilateral changes to the written agreements required under the final rule, these sections are being deleted. The FDIC retains its general supervision, examination, and enforcement powers and authorities to take any actions necessary (beyond the scope of the final rule), to ensure the safe or sound operations of any insured depository institution, including an industrial bank, and further to ensure that a parent of an industrial bank acts as a source of strength to that insured depository institution.

As described herein, the final rule will impact Covered Companies and their subsidiary industrial banks, as well as the FDIC's review of affected filings and the ongoing supervision of organizations approved under the final rule. Given these impacts, staff will provide a report to the Board regarding the implementation and effects of the final rule, based on activity during the twelve months following its effective date.

Conclusion

Staff recommends that the Board adopt the attached final rule and authorize its publication in the *Federal Register* with an effective date of April 1, 2021, which is the first day of the calendar quarter that begins on or after the date the rule is published in final form.

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