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The Return of the ILC: The FDIC Issues a Proposal and Approval Orders

March 20, 2020

On March 17, 2020, the Federal Deposit Insurance Corporation (the "FDIC") proposed a regulatory framework to strengthen and codify the FDIC process for approving industrial bank insurance applications and the supervision of industrial bank holding companies (the "Proposal"). The comment period of the Proposal ends 60 days after the Proposal has been published in the Federal Register. The following day, the FDIC published the approvals for Federal deposit insurance (the "Approval Orders") for the proposed Utah-charted industrial banks Nelnet Bank and Square Financial Services, Inc. (collectively, the "Approved Banks").

As background, current FDIC Chair Jelena McWilliams stated, even before she was confirmed, that she would be willing to approve FDIC insurance for worthy industrial bank applications. The FDIC's recent actions confirm that industrial banks are again an option for FinTechs, non-bank-centric financial services firms and others to enter the banking arena.

An "industrial bank" (also referred to as an "industrial loan company" or "ILC") is an FDIC-insured state bank that can be established in certain states, such as Utah, Nevada and California. Generally, industrial banks can provide the same products and services as any other FDIC-insured state bank charter, particularly to retail customers. However, unlike other state charters, the parent(s) of an industrial bank do not become bank holding companies regulated by the Federal Reserve. These charters became popular for non-bank-centric firms, including Wall Street brokerage houses and insurance firms, before the financial crisis, to provide banking services to their customers. However, due a variety of factors, the FDIC had not granted deposit insurance to allow an industrial bank to be formed since 2008.

The below summarizes the Proposal's applicability and requirements and how those requirements are reflected in the Approval Orders. Combined, they make several points clear: (i) the FDIC is willing to move forward with industrial bank applications for FDIC insurance, (ii) the Approval Orders are largely consistent with the Proposal and (iii) the perceived financial strength of the industrial bank holding company is important in the FDIC's evaluation of the requirements for approval.

PROPOSAL APPLICABILITY & OVERVIEW

The Proposal covers industrial banks that, after the effective date of the finalization of the Proposal, become subsidiaries of companies that are "Covered Companies." A "Covered Company", in turn, is generally defined to include any company that is not subject to Federal consolidated banking supervision by the Federal Reserve Board. The Proposal thus would not apply to industrial banks in existence before the finalization of the Proposal becomes effective (the "Grandfathered Industrial Banks") or their parent companies. The Proposal's requirements also would not apply to an industrial bank that is controlled by a company supervised by the Federal Reserve or wholly owned by one or more individuals. The Proposal would make a Grandfathered Industrial Bank subject to the final rule, however, following a change in control, merger or grant of deposit insurance occurring after the effective date of the final rule.

Proposed Application Conditions for Approval

Under the Proposal, Covered Companies and industrial banks would be required to enter into a written agreement with the FDIC. The Proposal contemplates that the written agreement would require Covered Companies to take the actions below:[1]

- provide the FDIC with an initial listing including annual updates of all of the Covered Company's subsidiaries;
- consent to the FDIC's examination of the Covered Company and each of its subsidiaries to monitor compliance with written agreements, commitments, conditions and certain provisions of law subject to FDIC oversight;
- provide the FDIC with an annual report of the Covered Company and its subsidiaries and other requested reports, which the Covered Company can expect will include its financial condition, systems for identifying, measuring, monitoring and controlling financial and operational risks, transactions with depository institution subsidiaries and compliance with any law or regulation, including the Federal Deposit Insurance Act;
- maintain records as the FDIC deems necessary to assess the risk to the industrial bank and to the Deposit Insurance Fund;
- cause an annual independent audit of the industrial bank;

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1 12 CFR § 354.5.

- ensure the Covered Company represents no more than 25% of the board of directors or board of managers, as applicable, of the industrial bank;

- maintain capital and liquidity levels of the industrial bank as required by the FDIC and take action to provide the industrial bank with a resource for additional capital or liquidity; and

- enter into a tax allocation agreement regarding tax assets generated by the industrial bank that expressly recognizes an agency relationship between the Covered Company and the industrial bank that provides that all tax assets are held in trust by the Covered Company.

Additionally, Covered Companies and industrial banks could be required to adopt, maintain and implement an FDIC-approved contingency plan regarding stress scenarios. If required, the plan would include a contingency plan for disposition of the industrial bank without the need for a receiver or conservator.

Proposed Supervisory ILC Requirements

Under the Proposal, an industrial bank controlled by a Covered Company would need prior written FDIC approval before taking any of the actions below:

- implementing material changes in its business plan;

- adding or replacing a member of the board of directors;

- adding or replacing a senior executive officer;

- employing a senior executive officer who is associated in any manner with an affiliate, including as a director, officer, employee, agent, owner or consultant; and

- entering into a contract for services material to the operations of the industrial bank with the Covered Company or any subsidiary of the Covered Company.

The FDIC also reserves its authority to impose, in its sole discretion, other restrictions on the activities or operations of an industrial bank.

ILC APPLICATION APPROVALS

FDIC Approves Two Industrial Bank Applications

On March 18, 2020, the FDIC published the Approval Orders for two new industrial banks. In addition to demonstrating that the FDIC is willing to move forward with industrial bank applications, the Approval Orders make clear that the perceived financial strength of the Covered Company is important in evaluating the requirements. Due to the perceived financial weakness of its parent company, Square, Inc., Square Financial Services, Inc. received more stringent conditions than those for Nelnet Bank.

In this regard, the FDIC generally required Covered Companies in both Approval Orders to comply with the requirements in the Proposal described above. However, two of the Proposal's requirements were implemented differently for the two Approved Banks, demonstrating the importance of the industrial bank's parent company's perceived ability to be a strong source of financial strength.

- *Leverage Ratio*: Nelnet Bank is required to maintain a 12 percent leverage ratio at all times, whereas Square Financial Services, Inc. is required to maintain a 20 percent leverage ratio at all times.

- *Reserve Deposit*: Nelnet, Inc. is required to establish and maintain a $40 million deposit account at Nelnet Bank that would be accessible to the Nelnet Bank in the event Nelnet, Inc. failed to provide the capital and liquidity support required in its Capital and Liquidity Agreement ("CALMA"). By contrast, Square, Inc. must establish and maintain a $50 million reserve deposit at an unaffiliated, third-party insured depository institution that the industrial bank could draw upon in the event it fails to provide sufficient funds as required under the provisions of its CALMA.

- Square, Inc. is also required to take additional action such as (i) maintaining a third-party line of credit acceptable to the FDIC for the benefit of Square Financial Services, Inc., (ii) submitting an annual business plan to the FDIC for review and approval and (iii) purchasing any loan from the industrial bank at the greater of the cost basis or fair market. Square Financial Services, Inc., but not Nelnet, Inc., includes in its Parent Company Agreement that its Covered Company must engage a third party to review and provide periodic reports concerning the effectiveness of Square, Inc.'s complaint response system if any material concerns are identified.

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