



MEMORANDUM TO: The Board of Directors

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

SUBJECT: Notice of Proposed Rulemaking
Parent Companies of Industrial Banks and Industrial Loan
Companies

Recommendation

Staff recommends that the FDIC Board of Directors (Board) approve the attached Notice of Proposed Rulemaking (proposal or NPR) and authorize its publication in the Federal Register for a 60-day comment period. The NPR proposes a new rule, Part 354 of the FDIC Rules and Regulations (Part 354), that would apply to each deposit insurance application approval, non-objection to a change in control notice, and merger application approval (together, filings) that would result in an industrial bank or industrial loan company (industrial bank) becoming, after the effective date of the final rule, a subsidiary of a company that is not subject to consolidated supervision by the Board of Governors of the Federal Reserve System (FRB) (Covered Company).¹

The proposal would require each Covered Company and the subsidiary industrial bank to 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 proposal would also prohibit the industrial bank from taking certain actions without the FDIC's prior written approval.

Staff believes the proposal would provide important safety and soundness protections with respect to industrial banks and the Deposit Insurance Fund (DIF) without imposing undue costs on industrial banks or Covered Companies, and would provide transparency to interested parties concerning the FDIC's determinations on filings involving industrial banks.

Concur:

Nicholas J. Podsiadly
General Counsel

¹ Such supervision is hereinafter referred to as "Federal consolidated supervision."

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 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).² As a result, parent companies of industrial banks are not subject to the BHCA’s activities restrictions or FRB supervision and regulation.³

Industrial banks are currently chartered in California, Hawaii, Minnesota, Nevada, and Utah.⁴ Under the CEBA, these states were permitted to grandfather existing industrial banks and charter new industrial banks because each state, on March 5, 1987, had in effect or had under consideration in the respective State's legislature a statute that required or would require industrial banks to obtain insurance under the Federal Deposit Insurance (FDI) Act.⁵ Generally, industrial banks offer limited deposit products, a full range of commercial and consumer loans, and other banking products and services.

Recent filings involving industrial banks have proposed ownership and control structures that would not be subject to Federal consolidated supervision, as well as affiliate relationships and business models that present unique circumstances or have not been tested through economic cycles. Staff believes a rule that generally codifies and enhances the FDIC’s current supervisory processes and policies would address potential risks to industrial bank subsidiaries and the DIF, while also providing transparency to interested parties concerning the FDIC’s practices when making determinations on filings involving industrial banks.

Statutory Authority

The FDIC has authority to issue rules to carry out the provisions of the FDI Act,⁶ including rules to ensure the safety and soundness of industrial banks and to protect the 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.

² Pub. L. 100-86, 101 Stat. 552 (Aug. 10, 1987).

³ 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.

⁴ Colorado was also grandfathered, but it has no active industrial banks and has since repealed its industrial bank statute.

⁵ See Section 2(c)(2)(H)(i) of the BHCA, 12 U.S.C. 1841(c).

⁶ See Sections 9(a) and 10(g) of the FDI Act, 12 U.S.C. 1819(a)(Tenth), 1820(g).

In granting deposit insurance for any insured depository institution, including industrial banks, the FDIC must assess the safety and soundness of the proposed institution, and the risk posed to the DIF. The FDIC may also permit or deny a merger or change in bank control by a state nonmember bank based in part on safety and soundness and risk to the DIF.⁷ In addition, as it relates to industrial banks that would be subject to the final rule, the FDIC must require Covered Companies to serve as a source of financial strength for the industrial bank.⁸

Consistent with this authority and the FDIC's mission, its role as deposit insurer, and as the appropriate Federal banking agency for industrial banks,⁹ the FDIC possesses the necessary authority to adopt Part 354. Further, the appropriateness of adopting the proposal is supported by the concerns arising from recent filings, including concerns regarding the ownership and control structures, affiliate relationships, and business models. The mechanisms that are incorporated into the proposal will enhance the FDIC's supervisory processes and practices during a variety of economic cycles, and will, in the aggregate, contribute to protecting the DIF.

Discussion of the Proposal

The proposal would codify, strengthen, and provide transparency to the public for the FDIC's current supervisory processes and policies regarding filings involving industrial banks controlled by Covered Companies.

Section 354.1 – Scope

This section describes the industrial banks and parent companies that would be subject to the Part 354. The proposal would apply to industrial banks that, on or after the effective date, become subsidiaries of Covered Companies. The term "Covered Company" is defined in Section 354.2 as any company that is not subject to Federal consolidated supervision and that, directly or indirectly and pursuant to Part 354, controls an industrial bank as a result of: (i) the grant of deposit insurance under Sections 5 and 6 of the FDI Act,¹⁰ (ii) a change in bank control under Section 7(j) of the FDI Act,¹¹ or (iii) a merger transaction pursuant to Section 18(c) of the FDI Act.¹²

Existing industrial banks and the respective parent companies, before the effective date of Part 354, would not be subject to the rule. However, such entities may become subject to the

⁷ See Sections 5, 6, and 8 of the FDI Act, 12 U.S.C. 1815, 1816, & 1818.

⁸ See 12 U.S.C. 1831o-1.

⁹ 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.

¹⁰ 12 U.S.C. 1815 and 1816.

¹¹ 12 U.S.C. 1817(j).

¹² 12 U.S.C. 1828(c).

final rule following a change in control or merger, assuming the resulting institution is an industrial bank and will be a subsidiary of a Covered Company.¹³

Importantly, an industrial bank and its respective parent company would not be subject to Part 354 if the parent company is subject to Federal consolidated supervision. Further, industrial banks that are not subsidiaries of a company (for example, an industrial bank wholly owned by one or more individuals) would not be subject to Part 354. The proposal's scope is summarized in the table below.

Description	Covered	Not Covered
Industrial banks that become subsidiaries of Covered Companies on or after the effective date.	✓	
Industrial banks that, before the effective date, are subsidiaries of a company not subject to Federal consolidated supervision.		✓
Industrial bank subsidiaries of companies that are subject to Federal consolidated supervision.		✓
Industrial banks that are not subsidiaries of a company.		✓

Section 354.3 – Written Agreement

This section would prohibit any industrial bank from becoming a subsidiary of a Covered Company unless the Covered Company enters into one or more written agreements with the FDIC and its subsidiary industrial bank. In such agreements, the Covered Company would make certain required commitments to the industrial bank and the FDIC. The commitments would include those listed in Section 354.4, and any other provisions the FDIC deems appropriate.

When two or more Covered Companies will control an industrial bank, as control is defined in the rule, each such Covered Company would be required to execute a written agreement in accordance with Section 354.3.¹⁴ In addition, in certain instances the FDIC may require, in its sole discretion, that a controlling shareholder of a Covered Company join as a party to any written agreement. In such cases, the 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.

¹³ Thus, a grandfathered industrial bank would be subject to Part 354, as would its parent company that is not subject to Federal consolidated supervision, if such a parent company acquired control of the grandfathered industrial bank pursuant to a change in bank control transaction that closes after the effective date or if the grandfathered industrial bank is the surviving institution in a merger transaction that closes after the effective date.

¹⁴ This circumstance could occur, for example, (i) when two or more Covered Companies will each have the power to vote 10 percent or more of the voting stock of an industrial bank or of a company that controls an industrial bank, the stock of which is registered under Section 12 of the Securities Exchange Act of 1934, or (ii) when one Covered Company will control another Covered Company that directly controls an industrial bank.

Section 354.4 – Required Commitments and Provisions of a Written Agreement

The required commitments are intended to provide the safeguards and protections necessary to maintain the safety and soundness of industrial banks that are controlled by Covered Companies. The majority of the required commitments, generally, have been incorporated into prior approvals or nonobjections. The FDIC’s use of the commitments has been to create an appropriate supervisory structure for industrial banks controlled by a Covered Company. The table below describes each of the eight proposed commitments.

NPR Citation	Commitments of Covered Company and, as appropriate, Controlling Shareholder(s)
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 condition, operations, prospects, and risk profile of the Covered Company and its subsidiaries.
354.4 (a)(2)	Consent to Examination. Consent to the 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 such other actions to provide the industrial bank with the resources for additional capital or liquidity.

NPR Citation	Commitments of Covered Company and, as appropriate, Controlling Shareholder(s)
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, ¹⁵ addresses tax allocation. The proposal similarly seeks to avoid potential harm to the industrial bank subsidiary by requiring a written tax allocation agreement.

Section 354.4(b) would also set forth the FDIC’s authority to impose, as an additional commitment, a requirement that the Covered Company provide to the FDIC and thereafter adopt a contingency plan that, among other items, sets forth recovery actions to address significant financial or operational stress that could threaten the safe and sound operation of the industrial bank and strategy(ies) for the orderly disposition of the Covered Company’s subsidiary industrial bank. In the case where a contingency plan is a condition to approval of an application or nonobjection to a notice, the FDIC may take into account the size, complexity, and interdependencies among the industrial bank and its affiliates, and other factors relevant to the industrial bank and Covered Company. Section 354.4(c) also provides the FDIC with the ability, at its sole discretion, to require any other commitments.

In addition to the required written agreements, the FDIC will continue to include appropriate conditions in any approval or nonobjection. Such conditions may include standard conditions provided in Section 303.2, as well as any other conditions deemed appropriate under the facts and circumstances.¹⁶ Because the FDIC may enforce conditions imposed in writing in connection with any action on any application, notice, or other request by an industrial bank or a company that controls an industrial bank,¹⁷ it is not necessary to include provisions regarding conditions in the proposed rule.

Section 354.5 – Restrictions on Industrial Bank Subsidiaries of Covered Companies

Section 354.5 would require 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.

¹⁵ 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).

¹⁶ 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(dd) for a list of standard conditions.

¹⁷ 12 U.S.C. 1818(b); 1831aa(a).

NPR Citation	Action	Support for Prior Approval
354.4(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.
354.4(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.
354.4(a)(3)	Add or replace a senior executive officer.	
354.4(a)(4)	Employ a senior executive officer who is associated in any manner with an affiliate.	
354.4(e)	Enter into any contract for material services with the Covered Company or a subsidiary thereof.	

Under Section 354.4, the FDIC could impose, on a case-by-case basis, additional restrictions on an industrial bank’s activities or operations if circumstances warrant.

Section 354.6 – Reservation of Authority

Section 354.6 clarifies 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.

Conclusion

Staff recommends that the Board approve the attached NPR for publication in the Federal Register for a 60-day comment period.

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