

December 29, 2020

Regulation of Industrial Bank Parent Companies

FDIC Adopts Final Rule Requiring Certain Conditions and Commitments for Insured Industrial Banks or Industrial Loan Companies With Parents That are not Subject to Regulation by the Federal Reserve Board

SUMMARY

On December 15, 2020, the Federal Deposit Insurance Corporation (the “FDIC”) approved a final rule (the “Final Rule”)¹ governing parent companies of industrial banks and industrial loan companies (collectively, “industrial banks”),² largely adopting the proposed rule issued in March 2020.³ The Final Rule is intended to “codify existing practices utilized by the FDIC to supervise industrial banks and their parent companies,”⁴ “ensure the safe and sound operation” of industrial banks,⁵ and provide “necessary transparency” regarding the FDIC’s supervisory practices.⁶ The Final Rule requires a company that is not subject to consolidated supervision by the Board of Governors of the Federal Reserve System (the “Federal Reserve”) and that controls an industrial bank as a result of a change in bank control, merger, or *de novo* process (such company, a “Covered Company”), to enter into one or more written agreements with the FDIC and its industrial bank subsidiary. These written agreements must include certain commitments intended to protect the safety and soundness of the industrial bank and provide the FDIC with information similar to that which would be provided if the Covered Company were subject to consolidated supervision by the Federal Reserve.

The Final Rule is largely consistent with the proposed rule, but makes four substantive changes:

- The threshold regarding the limitation of a Covered Company’s representation on the board of a subsidiary industrial bank has been raised from 25 percent to less than 50 percent.

SULLIVAN & CROMWELL LLP

- The Final Rule requires compliance from covered entities on or after the Effective Date, rather than simply after the Effective Date.
- The Final Rule requires additional reporting by Covered Companies regarding systems for protecting the security, confidentiality and, integrity of consumer and nonpublic personal information.
- The Final Rule applies the requirement that Covered Companies obtain the FDIC's prior written approval to add or replace a director or senior executive officer only during the first three years after the industrial bank becomes a subsidiary of a Covered Company.⁷

The Final Rule becomes effective on April 1, 2021 (the "Effective Date").⁸

FINAL RULE

A. SCOPE

The Final Rule applies to all industrial banks⁹ that, on or after the Effective Date, become subsidiaries of "Covered Companies."¹⁰ Covered Company is defined to be any company that (1) is not subject to consolidated supervision by the Federal Reserve (as are, for example, bank holding companies and savings and loan holding companies) and (2) controls an industrial bank (i) as a result of a change in bank control pursuant to the Change in Bank Control Act of 1978 ("CIBC Act"),¹¹ (ii) as a result of a merger transaction pursuant to the Bank Merger Act¹² or (iii) that is granted deposit insurance by the FDIC pursuant to section 6 of the Federal Deposit Insurance Act (the "FDIA"), in each case on or after the Effective Date.¹³ Importantly, the Final Rule does not apply to an industrial bank that (1) was, prior to the Effective Date, a subsidiary of a company that would otherwise be a Covered Company had it acquired the industrial bank on or after the Effective Date, (2) is controlled by a company subject to consolidated supervision by the Federal Reserve, or (3) is not (or will not become) a subsidiary of a company (*i.e.*, is controlled by a natural person).¹⁴ However, such an industrial bank and its parent company could later become subject to the Final Rule if a "parent company acquired control of [such] industrial bank pursuant to a grant of deposit insurance after the [E]ffective [D]ate,¹⁵ a change in bank control transaction that closes after the [E]ffective [D]ate, or if [such] industrial bank is the surviving institution in a merger transaction that closes after the [E]ffective [D]ate."¹⁶

The Final Rule defines control as "the power, directly or indirectly, to direct the management or policies of a company or to vote 25 percent or more of any class of voting securities of a company," and includes the rebuttable presumptions of control and "acting in concert" set forth Section 303.82(b) of the FDIC's regulations implementing the CIBC Act.¹⁷ Although this control definition is largely consistent with the definition of control in the CIBC Act and the FDIC's implementing regulations, the Final Rule broadens the definition to apply to control of a company and not solely an insured depository institution.¹⁸ By so doing, the control definition in the Final Rule can "accurately describe the relationship between the parent company of an industrial bank and any of its nonbank subsidiaries, which also would be affiliates of the industrial bank."¹⁹

SULLIVAN & CROMWELL LLP

B. WRITTEN AGREEMENTS AND COMMITMENTS

Under the Final Rule, no industrial bank can become a subsidiary of a Covered Company unless the Covered Company has entered into one or more written agreements with both the FDIC and the industrial bank.²⁰ The Covered Company must commit in such written agreements to:

- Submit to the FDIC an initial listing of all of the Covered Company's subsidiaries and update such list annually;
- 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 such Covered Company or subsidiary, and all relevant laws and regulations;²¹
- 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 to inform the FDIC as to the Covered Company's:²²
 - 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;
- Maintain such records as the FDIC may deem necessary to assess the risks to the subsidiary industrial bank or to the Deposit Insurance Fund;
- Cause an independent audit of each subsidiary industrial bank to be performed annually;
- Limit the Covered Company's direct and indirect representation on the board of directors or board of managers, as the case may be, of each subsidiary industrial bank to less than 50 percent of the members of such board of directors or board of managers, in the aggregate, and, in the case of a subsidiary industrial bank that is organized as a member-managed limited liability company, limit the Covered Company's direct and indirect representation as a managing member to less than 50 percent of the managing member's ownership interests in the subsidiary industrial bank, in the aggregate;
- Maintain the capital and liquidity of the subsidiary industrial bank at such levels as the FDIC deems appropriate, and take such other actions as the FDIC deems appropriate to provide the subsidiary industrial bank 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 industrial bank; and
- Execute a tax allocation agreement with its subsidiary industrial bank that expressly states that an agency relationship exists between the Covered Company and the subsidiary industrial bank with respect to tax assets generated by such industrial bank, and that further states that all such tax assets are held in trust by the Covered Company for the benefit of the subsidiary industrial bank and will be promptly remitted to it. The tax allocation agreement also must provide that the amount and timing of any payments or refunds to the subsidiary industrial bank by the Covered Company should be no less favorable than if the subsidiary industrial bank were a separate taxpayer.²³

According to the FDIC, the commitments set forth above are "intended to provide the safeguards and protections that the FDIC believes are prudent to impose to maintain the safety and soundness of industrial

SULLIVAN & CROMWELL LLP

banks that are controlled by Covered Companies . . . [and] establish a level of information reporting and parent company obligations similar to that which would be in place if the Covered Company were subject to Federal consolidated supervision.”²⁴

The FDIC will condition “each grant of deposit insurance, each issuance of non-objection to a change in control, and each approval of a merger” on compliance with the commitments set forth above.²⁵ Furthermore, the FDIC may, at its sole discretion, require a person who is a controlling shareholder of a Covered Company to be a party to any written agreement required by the Final Rule.²⁶ In such a circumstance, the controlling shareholder would be required to cause the Covered Company to fulfill its obligations under the written agreement, through the voting of shares, or otherwise.²⁷

C. CONTINGENCY PLAN

The FDIC may also require a Covered Company and industrial bank to commit to provide, implement, and adhere to, a contingency plan subject to the FDIC’s approval that sets forth, at a minimum, recovery actions to address significant financial or operational stress that could threaten the safety and soundness of the industrial bank and one or more strategies for the orderly disposition (such as sale of the industrial bank to, or merger with, a third party) of such industrial bank without the need for the appointment of a receiver or conservator.²⁸ In the Adopting Release, the FDIC notes that the contingency plan commitment “would only be required in certain circumstances based upon the facts and circumstances presented, and after taking into consideration size, complexity, interdependencies and other relevant factors.”²⁹ The Adopting Release also clarifies that the contingency plan is not the same as a resolution plan required under Section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act or Section 360.10 of the FDIC’s Rules and Regulations, and notes the contents of a contingency plan would be far less complex.³⁰ The contingency plan would be an “explanation of the steps the industrial bank and Covered Company could take to mitigate the impacts of financial and operational stress outside of the receivership process.”³¹ The Final Rule does not provide any further detail with respect to the informational requirements of a contingency plan.

D. ACTIVITY RESTRICTIONS

The Final Rule restricts the ability of an industrial bank controlled by a Covered Company to take any of the following actions without the FDIC’s prior written approval:³²

- Make a material change in its business plan after becoming a subsidiary of such Covered Company;
- Add or replace a member of the board of directors, board of managers, or a managing member of the subsidiary industrial bank during the first three years after becoming a subsidiary of such Covered Company;
- Add or replace a senior executive officer³³ during the first three years after becoming a subsidiary of such Covered Company;

SULLIVAN & CROMWELL LLP

- Employ 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 industrial bank; or
- Enter into any contract for services material to the operations of the industrial bank (for example, a loan servicing function) with such Covered Company or any subsidiary thereof.

In response to public comments requesting that the FDIC clarify what is meant by a “material change” to the industrial bank’s business plan, the Adopting Release sets forth certain changes or deviations that generally have been determined to constitute a material change in or deviation from an institution’s business plan:

- Increases in financial statement categories or subcategories (such as types of loans, funding, revenue, or capital) of 25 percent or more;
- Introduction of distinctly new or different business strategies or objectives, including products or services, target markets, delivery channels, or business development strategies;
- Changes to the institution’s financial strategies, or the acquisition of assets, an operating entity, or the assumption of deposits or other liabilities; or
- Changes in organizational relationships such that the manner in which the institution implements or carries out its business strategies or objectives is impacted.³⁴

Similar to the commitments described above, these activity restrictions are intended to “provide the safeguards and protections that the FDIC believes would be prudent to impose with respect to maintaining the safety and soundness of industrial banks that become controlled by companies that are not subject to Federal consolidated supervision.”³⁵

E. RESERVATION OF AUTHORITY

Importantly, the FDIC retains the authority to take supervisory or enforcement actions, including actions to address unsafe or unsound practices or conditions, or violations of law.³⁶ Pursuant to this reservation of authority, the FDIC could require that industrial banks and their parent companies that are not subject to consolidated supervision enter into written agreements, provide additional commitments, or abide by additional restrictions if necessary to maintain the safety and soundness of the industrial bank.³⁷ Furthermore, the FDIC may require written commitments and/or impose restrictions in the context of a particular industrial bank and its parent company to mitigate risk and to ensure the safe and sound operation of the industrial bank, even if not in connection with a filing pursuant to the Final Rule.³⁸

Industrial bank applications filed prior to the Effective Date will be considered on a case-by-case basis, and the FDIC may “impose conditions and requirements as appropriate and that are consistent with current practice and the FDIC’s general examination, supervision and enforcement authorities.”³⁹

* * *

ENDNOTES

- 1 The FDIC approved the Final Rule by a vote of 3 to 1 (with Director Gruenberg dissenting).
- 2 FDIC, *Parent Companies of Industrial Banks and Industrial Loan Companies* (December 15, 2020), available at <https://www.fdic.gov/news/board/2020/2020-12-15-notice-dis-b-fr.pdf> (the “Adopting Release”).
- 3 *Parent Companies of Industrial Banks and Industrial Loan Companies*, 85 Fed. Reg. 17771 (proposed March 31, 2020).
- 4 Adopting Release at 4.
- 5 *Id.* at 5.
- 6 *See id.* at 22.
- 7 *Id.* at 5-6.
- 8 *Id.* at 1.
- 9 The Final Rule defines an industrial bank as “any insured State bank that is an industrial bank, industrial loan company, or other similar institution that is excluded from the definition of the term ‘bank’ in section 2(c)(2)(H) of the Bank Holding Company Act.” Final Rule at § 354.2.
- 10 *See* Adopting Release at 47.
- 11 12 U.S.C. § 1817(j).
- 12 12 U.S.C. § 1828(c).
- 13 *See* Final Rule at § 354.2.
- 14 *See id.* at § 354.1(b).
- 15 Although the Adopting Release clarifies that the Final Rule would apply if an existing industrial bank obtains deposit insurance after the Effective Date, it is unclear when this would apply, as no existing operating industrial banks are uninsured.
- 16 Adopting Release at 45.
- 17 *See* Final Rule at § 354.2.
- 18 *See* Adopting Release at 51.
- 19 *Id.* Commenters suggested that the definition of control in the Final Rule should incorporate the definition of control used in the Bank Holding Company Act of 1956 (the “BHC Act”) and the Federal Reserve’s implementing regulations. The FDIC rejected this approach, noting that it “is not the Federal banking agency responsible for implementing and interpreting the [BHC Act] and has not developed precedent for the implementation of the [BHC Act].” Furthermore, the FDIC noted that “it found the logic of the [Federal Reserve’s] interpretations regarding control under the [BHC Act] useful in analyzing fact patterns under the [CIBC Act], but did not adopt the [Federal Reserve’s] interpretations, preferring instead to review each case based on the facts and circumstances presented.” *Id.* at 52.
- 20 Final Rule at § 354.4(a).
- 21 The Adopting Release notes that “the FDIC believes that the examination reviews envisioned under the [F]inal [R]ule enhance the existing supervisory practices and allow for a more robust evaluation of the industrial bank’s affiliate relationships” and “[t]hrough examination and reporting, the FDIC will be able to gauge and monitor the operational risks an industrial bank affiliate, whether functionally regulated or unregulated, presents to the industrial bank.” Adopting Release at 60-61.
- 22 The Adopting Release states that if a Covered Company is required to submit reports to the Securities and Exchange Commission (SEC), the annual report submitted by a Covered Company

ENDNOTES (CONTINUED)

may be satisfied through submission of the Covered Company's Form 10-K (or equivalent), along with the Covered Company's annual audit report and management letter (along with management responses), provided that the combination of reports addresses the requirements set forth in the Final Rule. The Adopting Release further provides that "[i]n some cases, it may be necessary or appropriate to also submit evaluations of the Covered Company's internal operations, along with management responses, satisfying the Statement on Standards for Attestation Engagements (SSAE) Number 18, *Report on Controls at a Service Organization Relevant to User Entities' Internal Control over Financial Reporting*, as issued or amended by the Auditing Standards Board, or similar reports or evaluations." See Adopting Release at 61 n.114.

23 Final Rule at § 354.4(a).

24 Adopting Release at 58-59.

25 Final Rule at § 354.4(a).

26 See *id.* at § 354.3(b).

27 See Adopting Release at 57.

28 See Final Rule at § 354.4(b); Adopting Release at 69.

29 Adopting Release at 70.

30 See *id.*

31 *Id.*

32 See Final Rule at § 354.5.

33 The Final Rule in Section 354.2 defines "senior executive officer" by reference to Section 303.101(b) of the FDIC's regulations, which defines a "senior executive officer" as "a person who holds the title of president, chief executive officer, chief managing officer (in an insured state branch of a foreign bank), chief financial officer, chief lending officer, chief investment officer, or, without regard to title, salary, or compensation, performs the function of one or more of these positions." Section 303.101(b) also includes in the definition of "senior executive officer" "any other person identified by the FDIC, whether or not hired as an employee, with significant influence over, or who participates in, major policymaking decisions of the bank."

34 Adopting Release at 77.

35 *Id.* at 73.

36 Final Rule at § 354.6.

37 See Adopting Release at 78.

38 See *id.*

39 See *id.*

SULLIVAN & CROMWELL LLP

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications by sending an email to SCPublications@sullcrom.com.