Financial Services Management

ILC-Parent Support Obligations

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and Industrial Loan Companies

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https://www.fdic.gov/news/board/2020/2020-12-15-notice-dis-b-fr.pdf

Impact Assessment

- New ILCs will be subject to a consistent regime of reports and disclosures the FDIC believes will ensure that nonbank companies understand and are able to serve as sources of strength for ILCs.
- Although patterned after BHC requirements, none in the FDIC regime for ILCs is quantitative or binding and many are also not transparent.
- New reports to the FDIC are added in the final rule to address concerns about data use, privacy, and system integrity, but these also do not match existing BHC requirements nor address many emerging concerns.
- Absent a change of regulatory policy or Congressional action, many ILCs are likely to be chartered to take advantage of continuing access to key bank benefits without costly regulation.

Overview

Setting the stage for new charters and legislative battles in 2021, the FDIC has finalized a controversial proposal[1] addressing source-of-support and certain other obligations for the parent companies of some industrial banks and industrial loan companies (ILCs). While these formalize and to some extent increase standards now applied to nonbank parents, the new requirements nonetheless are far less binding than the obligations imposed on bank holding company parents of banks that compete head on with these ILCs. The FDIC rule does not address, as it likely could not without statutory change, the broad commercial powers also allowed nonbank-bank parents, but the safety-and-soundness restrictions in the final rule are eased from the proposal and thus permit still greater integration of traditional banking with

[1] See **ILC14**, *Financial Services Management*, April 13, 2020.

nontraditional activities under a less stringent supervisory, regulatory, source-of-strength, and conflict-of-interest construct. The final rule adds new reporting obligations related to the use of non-public personal information and broader consumer data, but this does not establish safeguards at the parent company or the other controls mandated for other banking organizations, an issue also of growing concern given the activities of fintech and tech-platform (BigTech) companies. Resilience and resolution planning is also optional for these entities, a departure from stringent requirements applicable across traditional banks and very binding for larger BHCs.

Impact

At the heart of this controversial rule is the extent to which commerce and banking are allowed to merge in a single organization that, via a subsidiary, obtains access to FDIC insurance, the payment system, and the Federal Reserve's discount window. In the NPR and this final rule, the FDIC takes the view that Congress has authorized the ILC charter and thus blessed the integration of banking and commerce in the context of certain chartering limitations. Those objecting to this rule do not dispute current law *per se*, but counter that the existence of ILCs does not validate the absence also of parent-company regulation akin to that in a BHC except with regard to the parent company's lines of business.

Commenters also noted that, while some ILC parents engage in activities permitted for BHCs, the absence of BHC-like parent obligations also raises risks regardless of the nature of these parent activities. As a result, commenters argued that the FDIC has full authority to mandate an array of safety-and-soundness standards and, they say, these should go beyond those governing BHCs because of the added risks associated with non-financial lines of business or non-traditional financial services offered in ways often not possible for traditional insured depository institutions (IDIs).

Given the now-irreconcilable nature of this difference of opinion, it may fall to Congress next year to determine the extent to which parent companies of ILCs require BHC-like prudential standards. Indeed, the issues involved here transcend those directly addressed by the FDIC in this final rule. The OCC has also begun to authorize a series of non-traditional charters, most recently considering one from a fintech that would skirt an array of bank-like rules as well as those governing parent companies.[2] The OCC has yet to adopt anything close to the FDIC's parent-company standards by rule or public guidance for its innovative charters, providing still more scope for banking organizations controlled by commercial or otherwise non-traditional parent companies to gain payment-system access and other privileges while circumventing costly BHC and national-bank requirements.

The issue of non-traditional bank charters not only raises longstanding battles over the interaction of banking and commerce, but also new policy questions in the context of the role of large tech-platform companies and possible antitrust violations. Commenters opposing this NPR argued that allowing BigTech firms to acquire an IDI, even under these additional parent-company restrictions, could empower giant conglomerates using big data with tremendous market-concentrating effect. This concern has also been raised by global regulators, who in 2017 noted the potential of

[2] See *Client Report* **CHARTER28**, December 8, 2020.

"natural oligarchies" as tech platforms expanded their financial-services footprint.[3] The FDIC refutes this concern on grounds that it has the authority to address competitiveness considerations when it grants an ILC charter. It is not, however, clear if the agency has the authority granted antitrust authorities to understand the full scope of a parent company's operation or force divestiture if conditions applicable at chartering cease to apply. The agency's authority over data safeguards is also considerably more limited than likely to be necessary to prevent big-data use with problematic consumer or systemic impact. Reflecting this, the final rule now includes a requirement that parent companies inform the FDIC on their data-protection policies. The FDIC also reserves the right on a case-by-case basis to address data use.

Commenters opposed to this rule also cited concerns regarding the application of Sections 23A and 23B of the Federal Reserve Act governing inter-affiliate transactions. The FDIC rejects these on grounds that these sections apply to ILCs and the FDIC has the authority to enforce them. However, the FDIC also notes that it does so with regard to ensuring the safety and soundness of the IDI and the financial system. It is less clear if these inter-affiliate transactions are sufficient or could be enforced to ensure effectiveness with regard to inter-affiliate transfers of non-financial holdings of value such as big data where price comparisons to the rest of the market are at best challenging. These sections also only cover transactions from an IDI to affiliates that might put the IDI at risk. Transactions from the parent company that seemingly add value to the bank but pose antitrust, privacy, and other concerns are less clearly addressed by these inter-affiliate standards or other supervisory tools readily available to the FDIC.

What's Next

This rule was approved on a 3-1 vote by the FDIC board on December 15. It is effective on April 1, 2021 and applies only prospectively to new ILCs without consolidated parent companies formed after that date or otherwise-grandfathered ILCs that undertake certain corporate changes.

The agency rejected moratoria or other pauses for ILC charters despite the pandemic on grounds that, as noted above, it believes it has an express statutory injunction to allow ILC charters under appropriate safety-and-soundness standards. The FDIC is an independent agency and thus not clearly subject to a Presidential executive order should the Biden Administration make halting non-traditional charters a priority as it readies an array of nominations to make longer-term policy changes across the banking agencies.

3 See *Client Report* **FINTECH15**, November 1, 2017.

Analysis

A. Scope

This rule applies only to prospective industrial banks and ILCs not subject to consolidated parent supervision, not also to limited-purpose trust companies and credit-card banks even though their owners may also not be subject to consolidated regulation. An individual with a controlling interest in a covered ILC's parent company (broadly defined to cover persons such as Mark Zuckerberg at Facebook) may be required to join as a party to the FDIC's agreement governing parent-company obligations.

B. Structure

The final rule does not, as the NPR considered, require ILC parents to establish intermediate holding companies (IHCs) to house an ILC. However, the FDIC retains the right to require this for foreign parent companies presenting unique concerns.

C. Written Agreements

To obtain a charter, the parent company and any other controlling party must agree in writing to:

- an initial list with annual updates of the parent company's subsidiaries;
- FDIC inspection of the parent company and all subsidiaries;
- maintain capital and liquidity at "appropriate" levels and take any other actions to provide additional capital and liquidity resources;
- provide the FDIC with an annual report on the parent company and its subsidiaries and any other records requested by the FDIC;
- depending on facts and circumstances (not spelled out in the rule), implement a contingency plan addressing resilience and recovery;
- maintain required information;
- submit an annual report on systems that protect consumer and non-public personal information security, confidentiality, and integrity;
- conduct an independent audit each year of the ILC;
- limit board membership to less than fifty percent (up from 25 percent in the NPR); and
- enter into a tax-allocation agreement, with tax assets held in trust for the ILC by the parent company.

D. Restrictions

FDIC permission would be required prior to:

- a material business-plan change after chartering;
- adding or replacing a director or member of senior management or employing a senior manager affiliated with the parent company within the past three years;
- entering into a contract for material services with the parent company or its subsidiaries; and
- complying with any other case-by-case restrictions. The agency also reserves its authority with regard to any other supervisory matter.