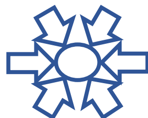

Financial Services Management

ILC Charters

Cite
S. 3538, Close the Shadow Banking Loophole Act

Recommended Distribution
Policy, Legal, Government Relations

Website
https://www.banking.senate.gov/imo/media/doc/close_the_shadow_banking_loophole_act1.pdf

Impact Assessment

- New ILC parent companies would come under FDIC supervision, examination, and reporting requirements addressing financial and operational risk. Some prospective parents may decide not to charter ILCs in consequence.
- These FDIC powers would not directly reduce banking/commerce integration or inter-affiliate transfers, leaving intact much nonbank competitive advantage.
- However, FDIC supervision could increase the likelihood that a parent company is able to serve as a source of strength for an ILC and can be required to do so, reducing FDIC resolution costs.
- The extent to which the FDIC is able to muster parent-company supervisory skills is uncertain.

Overview

Senate Banking Committee Chairman Brown (D-OH) is now leading a renewed bipartisan charge to limit the ability of nonbanks to use industrial loan companies (ILCs) to gain access to bank privileges without the parent-company supervision required of all other domestic IDI parents. However, supervision of such parent companies and their nonbank subsidiaries would come from the FDIC, not FRB. This would reduce what some believe to be the Fed's outsized role as bank and BHC supervisor, but the FDIC's ability to undertake new supervisory duties is unclear, especially in the wake of recent failures.[1] BHC rules such as limits on banking and commerce and consolidated prudential standards would not apply to ILC parents.

[1] See **REFORM222**, *Financial Services Management*, May 1, 2023.

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Impact

The Brown-Kennedy bill follows a raft of measures designed to curb ILCs that include prior initiatives by each of these senators.[2] It again follows a decision by the FDIC under its Trump-appointed chair to open ILC charters to nonbanks as long as the FDIC is confident of parent-company support.[3] Critics of that ruling feared undue interaction between nonbank parents and ILCs that would undermine the barrier between banking and commerce, give ILCs an unfair advantage over IDIs with regulated parents, and pose Deposit Insurance Fund or even systemic risk if the nonbank parent cannot or will not support an IDI subsidiary under stress.

At the time of its final rule in 2021, the FDIC countered that the law allows ILCs and that neither it nor the FRB had legal authority to scrutinize parent companies to ensure ongoing source-of-strength capacity. Neither it nor the FRB also have the authority to impose parent-company standards akin to those demanded of BHCs and foreign banking organizations controlling larger IDIs. This bill is an effort to respond to these omissions, but it does not give the FDIC direct authority to demand capital, liquidity, or other resources with which to ensure support of an ILC. Or address parent-company commercial and nonbank financial activities.

Whether the FDIC can ensure source-of-strength capacity at a parent company in practice and what it might do if it finds parent-company weakness is uncertain. As noted, the FDIC has had trouble supervising the largest banks within its jurisdiction. The Fed's record is also spotted due to Silicon Valley Bank's failure,[4] but it does have more experience with the types of complex companies most likely to own an ILC. Further, even if the FDIC finds that a parent company may be unable to ensure financial and operational strength at the ILC, its enforcement powers to correct lapses are uncertain. The bill's language may confine the FDIC to enforcement actions related to supervisory or reporting lapses that may not be able to ensure the rapid recapitalization or downstreamed liquid assets essential for resilience under stress.

What's Next

S.3538 was introduced on December 14 by Sen. Brown along with Sens. Kennedy (R-LA), Casey (D-PA), Van Hollen (D-MD), Braun (R-IN), and Wicker (R-MS). As noted, Sen. Brown has in the past pressed ILC constraints but failed to advance his or any other ILC legislation in the Senate Banking Committee. It remains to be seen if he will actively advance the bill to mark-up and then the Senate floor in 2024. Should he do so, it faces an uncertain future in the House despite strong support from banking-industry interests along with advocacy groups. The bill does not yet have a companion in the House.

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[2] See **ILC13**, *Financial Services Management*, December 16, 2019

[3] See **ILC15**, *Financial Services Management*, December 21, 2020

[4] See *Client Report* **REFORM221**, May 1, 2023.

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Analysis

A. Parent-Company Standards

As noted, the FDIC – not the FRB – would be considered the primary regulator of a covered ILC's parent company. The FDIC would be authorized to examine the parent company and obtain reports from the parent or any other subsidiary that is not a bank. These actions would be necessary to determine the parent company's financial condition, the parent company's systems or subsidiary for managing and controlling financial and operational risk, and perhaps also parent-company transactions with the ILC. The examination procedures and reports must follow those required by the FRB for BHCs.

The FDIC would also be empowered to impose restrictions on the parent or its nonbank subsidiaries and perhaps find ways through this power to enhance source-of-strength resources or even competitive equity because the bill authorizes the use of FDIC enforcement sanctions in the same manner as the FRB.

The FDIC would also get direct authority to supervise parent companies if the parent is not supervised by the FRB or another banking agency, is not a bank, or a state insurance regulator. The bill does not make clear how it differentiates this section regarding supervision from its provisions for FDIC examination and reporting.

B. Charter Conversion

Banking agencies would all be required to disapprove change-of-control notices regarding ILCs unless the entity is in danger of default, the new controlling party is regulated by the FRB, or if the change relates to minority holdings of publicly-traded stock.

C. Grandfather

The bill exempts ILCs chartered before the FDIC's rule became effective in 2021 that complied with the FDIC's conditions of approval.

Entities that had applications for FDIC insurance before the FDIC's rule became effective could also be grandfathered following an FDIC request for comment and public hearing. Any such charter could then only be approved by the FDIC board, not its staff. If the FDIC does not approve any such application by September 30, 2024, then the application is deemed denied.

The bill also includes provisions protecting the FDIC's ability to enforce agreements with ILC parents entered into prior to September 30, 2021 and – the drafting here is unclear – perhaps also enforce other requirements.

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