

**DRAFT**

[6714-01-P]

**FEDERAL DEPOSIT INSURANCE CORPORATION**

12 CFR Part 354

RIN 3064-AD15

**INDUSTRIAL BANK SUBSIDIARIES OF FINANCIAL COMPANIES**

**AGENCY:** Federal Deposit Insurance Corporation (FDIC).

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** The FDIC is publishing for comment proposed rules that would impose certain conditions and requirements on each deposit insurance application approval and non-objection to a change in control notice that would result in an insured industrial loan company or industrial bank (collectively “industrial bank” or “ILC”)<sup>1</sup> becoming, after the effective date of any final rules, a subsidiary<sup>2</sup> of a company that is engaged solely in financial activities and that is not subject to consolidated bank supervision by the Federal

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1 The term “industrial bank” or “ILC” means any insured State Bank that is an industrial bank, industrial loan company or other similar institution that is excluded from the definition of “bank” in the Bank Holding Company Act pursuant to 12 U.S.C. 1841(c)(2)(H).

2 The term “subsidiary” means any company that is controlled, directly or indirectly, by another company.

Reserve Board or the Office of Thrift Supervision (“Federal Consolidated Bank Supervision”). The proposed rules would also require that before any industrial bank may become a subsidiary of a company that is engaged solely in financial activities and that is not subject to Federal Consolidated Bank Supervision (a “Non-FCBS Financial Company”), such company and the industrial bank must enter into one or more written agreements with the FDIC. Simultaneously with the proposed rules, the FDIC is publishing a Notice to extend for one year its moratorium for applications for deposit insurance and change in control notices for industrial banks that will become subsidiaries of companies engaged in non-financial activities (“commercial companies”).<sup>3</sup> By this action, however, the FDIC is not expressing any conclusion about the propriety of ownership or control of industrial banks by commercial companies. The FDIC has determined that it is appropriate to provide additional time for review of such ownership and the related issues by the FDIC and by Congress.

**DATE:** Written comments must be received by the FDIC no later than [insert date 90 days after publication in the FEDERAL REGISTER].

**ADDRESSES:** You may submit comments, identified by RIN number 3064-AD15, by any of the following methods:

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<sup>3</sup> A financial activity is generally any activity that is permissible for a financial holding company or a savings and loan holding company. See the proposed section 354.2 for a detailed definition of the term. Any other activity is “non-financial.”

- Federal eRulemaking Portal: <http://www.regulations.gov>; submissions must include the agency's name ("FDIC") and the RIN (3064-AD15) for this rulemaking,
- Agency Web site: <http://www.FDIC.gov/regulations/laws/federal/propose.html>,
- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments/Legal ESS, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429.
- Hand Delivery/Courier: The guard station at the rear of the 550 17th Street Building (located on F Street), on business days between 7 a.m. and 5 p.m., or
- E-mail: [comments@FDIC.gov](mailto:comments@FDIC.gov). Include RIN number 3064-AD15 in the subject line of the message.

Public Inspection:

- Comments may be inspected and photocopied in the FDIC Public Information Center, Room E-1002, 3501 North Fairfax Drive, Arlington, VA, between 9 a.m. and 4:30 p.m. on business days.
- Comments received will be posted without change to <http://www.FDIC.gov/regulations/laws/federal/propose.html> and will include any personal information provided, except that the FDIC may redact any inappropriate matter.

**FOR FURTHER INFORMATION CONTACT:** Robert C. Fick, Counsel (202) 898-8962, A. Ann Johnson, Counsel (202) 898-3573 or Thomas P. Bolt, Counsel, (202) 898-6750, Federal Deposit Insurance Corporation, 550 17<sup>th</sup> Street, N.W., Washington, D.C. 20429.

## **SUPPLEMENTARY INFORMATION:**

### **Background**

#### I. History Of Industrial Banks

Industrial banks were first chartered in the early 1900's as small loan companies for industrial workers. Over time the chartering states have expanded the powers of their industrial banks to the extent that some industrial banks now have generally the same powers as state commercial banks.<sup>4</sup>

Industrial banks are state-chartered banks,<sup>5</sup> and all of the existing FDIC-insured industrial banks are "state nonmember banks" under the Federal Deposit Insurance Act (FDI Act). As a result, their primary Federal banking supervisor is the FDIC. The FDIC

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<sup>4</sup> Most of the industrial banks operating today do not offer demand deposits. Even in those states that have authorized industrial banks to offer demand deposits, industrial banks generally do not offer them. Offering demand deposits could, under certain circumstances, make any company that controls the industrial bank subject to supervision under the Bank Holding Company Act. *See generally, The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective*, Supervisory Insights (Summer 2004).

<sup>5</sup> 12 U.S.C. 1813(a)(2).

generally exercises the same supervisory and regulatory powers over industrial banks that it does over other state non-member banks.

While industrial banks are “banks” under the FDI Act,<sup>6</sup> they generally are not “banks” under the Bank Holding Company Act (BHCA).<sup>7</sup> One result of this difference in treatment is that a company that owns an FDIC-insured industrial bank could engage in commercial activities and/or may not be subject to Federal Consolidated Bank Supervision. By contrast, bank holding companies or savings and loan holding companies are generally prohibited from engaging in commercial activities. Another result is that some of the companies that own insured industrial banks are not subject to Federal Consolidated Bank Supervision. The FDIC has noted a recent increase in deposit insurance applications for, and change in control notices with respect to, industrial banks that would be affiliated with commercial concerns or other companies that would not have a Federal Consolidated Bank Supervisor.<sup>8</sup> Some members of Congress, the Government Accountability Office, the FDIC’s Office of Inspector General, and members of the public have expressed concerns regarding the lack of Federal Consolidated Bank Supervision, the uncertainty regarding the parent company’s willingness or ability to serve as a source of strength to the subsidiary industrial bank, the potential risks from mixing banking and commerce, the potential for conflicts of interest, and the potential for an “uneven playing field.”

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6 12 U.S.C. 1813(a)(2).

7 *See* 12 U.S.C. 1841(c)(2)(H).

8 The term “Federal Consolidated Bank Supervisor” means either the Federal Reserve Board or the Office of Thrift Supervision.

In 1987 Congress enacted the Competitive Equality Banking Act (CEBA)<sup>9</sup> which exempted companies that control certain industrial banks from the BHCA. The industrial bank industry has grown and evolved significantly since CEBA was enacted. As of year-end 1987, 105 industrial banks reported aggregate total assets of \$4.2 billion and aggregate total deposits of \$2.9 billion. The reported total assets for these industrial banks ranged from \$1.0 million to \$411.9 million, with the average industrial bank reporting \$40.0 million in total assets and \$27.3 million in total deposits.

Between 1987 and 2006 total assets held by industrial banks grew from \$4.2 billion to \$177 billion. In 1996 one large financial services firm moved its entire credit card operation into its subsidiary industrial bank, increasing the assets in the industry to \$22.6 billion. Within the period from 1999 to 2000 another large financial services firm moved approximately \$40 billion from uninsured funds into insured deposits in its subsidiary industrial bank.<sup>10</sup>

As of year-end 1999, the FDIC insured 55 industrial banks with aggregate total assets of \$43.6 billion and aggregate total deposits of \$22.5 billion. The reported total assets for these industrial banks ranged from \$2.4 million to \$15.6 billion, with 10 institutions reporting total assets of more than \$1 billion. The four largest institutions reported total assets of \$15.6 billion, \$4.4 billion, \$3.8 billion, and \$3.0 billion. Six other institutions

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<sup>9</sup> Public Law 100-86, 101 Stat. 552 (codified as amended in various sections of title 12 of the U.S. Code).

<sup>10</sup> Since 2000 at least three additional financial services firms that control industrial banks have offered their clients the option of holding their cash funds in insured deposits in the firms' industrial banks.

reported total assets of \$1.1 billion to \$2.5 billion. The remaining portfolio of industrial banks, on average, reported total assets of \$152.5 million.

Since January 1, 2000, 24 industrial banks became insured.<sup>11</sup> As of January 30, 2007, there were fifty-eight insured industrial banks<sup>12</sup> with aggregate total assets of approximately \$177 billion. Six industrial banks reported total assets of \$10 billion or more; eleven other industrial banks reported total assets of \$1 billion or more. The remaining forty-one institutions, on average, reported total assets of approximately \$231.8 million. Forty-five of those fifty-eight operated in Utah and California.<sup>13</sup> Of the fifty-eight existing industrial banks, forty-three were either owned by one or more individuals or controlled by a parent company whose business is financial in nature. As of January 30, 2007, thirty-one of the fifty-eight existing industrial banks were owned by financial companies that were not subject to Federal Consolidated Bank Supervision. Fifteen industrial banks were subsidiaries of holding companies that are commercial in nature. Eight of the fifty-eight industrial banks (representing approximately sixty-nine percent of industrial bank industry assets) were owned by companies that were engaged solely in financial activities and were subject to consolidated supervision by the FRB or the OTS. Four of the fifty-eight industrial banks were owned by individuals.

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11 During 2000, four new industrial banks were insured; two during each of 2001 and 2002; five during 2003; six during 2004; four during 2005; and one in 2006.

12 The difference between 79 (55 industrial banks at the end of 1999 plus 24 new ones since then) and 58 results from various mergers, conversions, voluntary liquidations and one failure. Aggregate asset figures are as of September 30, 2006, the most recent reported data.

13 Industrial banks also operate in Colorado, Hawaii, Indiana, Minnesota and Nevada.

## *Recent Developments*

While some of the industrial banks insured after CEBA are subject to Federal Consolidated Bank Supervision, many of the recent applications and notices are from companies that would have no Federal Consolidated Bank Supervisor. Currently, eight applications for deposit insurance for industrial banks are pending before the FDIC. In 2006, the FDIC also received seven notices of change in bank control to acquire an industrial bank.<sup>14</sup> None of the potential parent companies of the current industrial bank applicants or the potential acquirers of industrial banks would be subject to Federal Consolidated Bank Supervision.

In 2005, the Government Accountability Office (GAO) expressed its concern that industrial banks owned by commercial companies or other entities without a Federal Consolidated Bank Supervisor created an uneven playing field when compared to banks and thrifts owned by holding companies subject to Federal Consolidated Bank Supervision.<sup>15</sup> The GAO questioned whether the FDIC's examination, regulation, and supervision authorities were sufficient to protect such industrial banks. The concerns regarding the lack of consolidated supervision and the possible limitations of the FDIC's

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14 Five of the change in control notices have been withdrawn, and one was approved.

15 U.S. Gov't Accountability Office, GAO-05-621, *Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority* 79-80 (2005) (hereinafter "GAO Report 05-621").

authority echoed those previously expressed by the FDIC's Office of Inspector General in a 2004 report.<sup>16</sup>

Some industrial banks continue to be small, community-focused institutions. However, the FDIC has noted a recent increase in the number of applications for deposit insurance and notices of change in control for industrial banks that would be affiliated with commercial companies or other entities that would not be subject to Federal Consolidated Bank Supervision. These companies are often large organizations that tend to have complex business plans, and their subsidiary industrial banks tend to provide specialty lending programs or financial services or other support to the company.

Whatever their purpose or structure, the industrial bank charter has generated a significant amount of public interest in recent years as various entities have explored the feasibility and advantages associated with including an industrial bank as part of their operations.

In 2006, the FDIC received more than 13,800 comment letters regarding the proposed Wal-Mart Bank's 2005 deposit insurance application.<sup>17</sup> Most of these comments expressed opposition to granting deposit insurance to this particular applicant; however,

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<sup>16</sup> See Federal Deposit Insurance Corporation Office of Inspector General, Report No. 2004-048, The Division of Supervision and Consumer Protection's Approach for Supervising Limited-Charter Depository Institutions (2004) (hereinafter "OIG Report").

some commenters raised more universal concerns about industrial banks. Over 640 of the more general comments were specifically focused on the risk posed to the Deposit Insurance Fund by industrial banks owned by holding companies without a Federal Consolidated Bank Supervisor. Similar sentiments were expressed by witnesses during three days of public hearings held by the FDIC regarding the Wal-Mart application. In addition, The Home Depot also filed a change in control notice in connection with its proposed acquisition of EnerBank, a Utah industrial bank. In response to the request for public comment on the change in control notice, the FDIC received approximately 830 comment letters; almost all of them expressed opposition to the proposed acquisition.

Congress also has had a continuing interest in the industrial bank charter. Most recently, on July 12, 2006, the House Committee on Financial Services (Committee) held a hearing regarding industrial banks. At this hearing, General Counsels from the FDIC and the Federal Reserve Board ("FRB") testified before the Committee, discussing the history, characteristics, current industry profile, and supervision of industrial banks.<sup>18</sup> The FDIC's testimony noted that today's industrial banks are owned by a diverse group of financial and commercial entities. Among such entities are industrial banks that serve a particular lending, funding, or processing function within a larger organizational

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17 See the FDIC's web site at <http://www.fdic.gov/regulations/laws/walmart/>.

18 Industrial Loan Companies: A Review of Charter, Ownership, and Supervision Issues: Hearing Before the H. Comm. on Financial Services, 109th Cong. (2006). The Committee also heard testimony from G. Edward Leary, Commissioner for the Utah Department of Financial Institutions; Rick Hilman, Director of Financial Markets and Community Investment, U.S. Government Accountability Office; George Sutton, Former Commissioner for the Utah Department of Financial Institutions; Terry Jorde, Chairman, President, and CEO of CountryBank USA, Chairman of ICBA; John L. Douglas, Partner, Alston & Bird; Arthur C. Johnson, Chairman and CEO of United Bank of Michigan; Prof. Lawrence J. White, Professor of Economics, Stern School of Business of New York University; Michael J. Wilson, Director,

structure, and those that directly support one or more affiliate's commercial activities. The FDIC further noted that industrial banks may share employees and obtain critical support from affiliated companies. The business plans for these industrial banks differ substantially from the consumer lending focus of the original industrial banks. In addition to the hearings, three bills were introduced in the House in the last two years for the purpose of making either the FDIC or another banking agency the Federal consolidated bank supervisor for industrial bank holding companies and prohibiting ownership or control of an industrial bank by a commercial firm.<sup>19</sup>

To evaluate the concerns and issues raised with respect to industrial banks, on July 28, 2006, the FDIC imposed a six-month moratorium on FDIC action with respect to certain industrial bank applications or notices.<sup>20</sup> The FDIC declared the moratorium to enable it to further evaluate (i) industry developments, (ii) the various issues, facts, and arguments raised with respect to the industrial bank industry, (iii) whether there are emerging safety and soundness issues or policy issues involving industrial banks or other risks to the insurance fund, and (iv) whether statutory, regulatory, or policy changes should be made in the FDIC's oversight of industrial banks in order to protect the Deposit Insurance Fund or important Congressional objectives.<sup>21</sup>

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Legislative and Political Action Department, United Food and Commercial International Union. Also, several organizations submitted record statements.

19 See H.R. 698, 1<sup>st</sup> Sess. 110<sup>th</sup> Cong.(2007); H.R. 5746, 109th Cong., 2d Sess. (2006); H.R. 3882, 109th Cong., 1st Sess. (2005).

20 See Moratorium on Certain Industrial Loan Company Applications and Notices, 71 FR 43482 (August 1, 2006).

21 *Id.* at 43483.

## II. Request for Comments

On August 23, 2006, the FDIC published in the Federal Register a Notice with a Request for Public Comment on a wide range of issues concerning industrial banks.<sup>22</sup> The Notice presented 12 specific questions for consideration by commenters. The issues presented by the questions included the current risk profile of the industrial bank industry; safety and soundness issues uniquely associated with ownership of such institutions; the FDIC's practice with respect to evaluating and making determinations on industrial bank applications and notices; whether a distinction should be made when the industrial bank is owned by an entity that is commercial in nature; and the adequacy of the FDIC's supervisory approach with respect to industrial banks.

The FDIC received over 12,600 comment letters in response to the Notice during the comment period.<sup>23</sup> Approximately 12,485 comments were generated by what appears to be organized campaigns either supporting or opposing the proposed industrial bank to be owned by Wal-Mart or the proposed acquisition of Enerbank, also an industrial bank, by The Home Depot. The remaining comment letters were sent by individuals, law firms, community banks, financial services trade associations, existing and proposed industrial banks or their parent companies, the Conference of State Bank Supervisors, and two members of Congress. Of the total comments received, seventy-one commenters addressed specific substantive issues concerning the industrial bank industry and its regulation.

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22 See Industrial Loan Companies and Industrial Banks, 71 FR 49456 (August 23, 2006).

23 See <http://www.fdic.gov/regulations/laws/federal/2006/06comilc.html>.

## Summary of the Substantive Responses by Topic

### *i. The Current Risk Profile of the Industrial Bank Industry*

Some commenters stated that the significant growth in total industrial bank industry assets and deposits has not adversely affected the risk profile of the industry and, therefore, industrial banks, regardless of ownership, present no unique safety and soundness concerns. These commenters argued that the industrial bank industry presents significantly less risk, and is therefore superior in comparison to, the industry profiles for other insured institutions. These commenters also contended that a supervisory approach that focuses on the bank itself, as opposed to consolidated supervision, is more effective for their supervision because current restrictions on affiliate transactions adequately address conflicts of interest and other potential forms of risk. Some of these commenters questioned the propriety of measuring risk on an industry-wide basis, and encouraged the FDIC to assess risk on an institution-by-institution basis. In addition, these commenters largely discouraged assessing risk differently for industrial banks based on considerations such as whether an institution's owner is subject to Federal Consolidated Bank Supervision, arguing that what mattered was the individual institution and its particular characteristics. In the view of these commenters, these distinctions are arbitrary because there is no evidence showing that any particular form of ownership or supervision is safer in terms of risk than another.

Many commenters opposed any mixing of banking and commerce. Other commenters, however, also noted the recent growth in total industry assets and deposits and were concerned about the risks that may emerge from such growth, including for example, dilution of the Federal deposit insurance system, i.e., the growth of deposits at industrial banks could result in an increase of bank insurance premiums in order to bring the deposit insurance funds back to the designated reserve ratio. These commenters also noted an increase in the number of industrial banks owned by entities that are commercial in nature. They are concerned that these industrial banks present unique risks compared to other insured institutions primarily because they are not subject to Federal Consolidated Bank Supervision and, with respect to publicly traded parent companies of industrial banks, are primarily concerned with maximizing shareholder profit. Others also asserted that commercial ownership requires consolidated supervision because the FDIC lacks legal authority, staff or expertise to adequately supervise industrial banks owned by large commercial companies. Additionally, one commenter stated that absence of consolidated supervision for companies not subject to the Bank Holding Company Act meant that both commercial ownership and financial ownership posed increased risks, while some asserted that commercial ownership presents greater risks than financial ownership and others (discussed above) asserted that only commercial ownership poses risks.

As to determining how to distinguish between a company that is financial or commercial in nature, one commenter suggested that a company should be considered “financial” if

80 percent of its revenues came from financial activities, while another commenter proposed that 85 percent should be the determinative number.

*ii. FDIC's Current Practice When Making Determinations on Industrial Bank Applications and Notices*

Some commenters encouraged the FDIC to continue evaluating all industrial bank applications on a case-by-case basis. These commenters believe that the statutory criteria for evaluating industrial bank applications and notices are thorough and comprehensive, and asserted that any departure from those criteria might be held by a court to be arbitrary and capricious agency action. These commenters also urged the FDIC to continue conditioning Federal deposit insurance on a case-by-case basis, and they objected to any proposals to impose general restrictions on industrial banks that are not subject to consolidated supervision, arguing that general restrictions predicated solely on the nature or form of industrial bank ownership are arbitrary and capricious.

Other commenters proposed that the FDIC augment its current practice with respect to evaluating industrial bank applications and notices, and presented additional factors for the FDIC to consider. They argued that the FDI Act authorizes the FDIC to consider any factor reasonably related to safety and soundness, the risk presented to the Deposit Insurance Fund, and/or the convenience and needs of the community; therefore the FDIC may evaluate a parent company's motivation or purpose for chartering or acquiring an industrial bank, as well as the parent company's reputation, market reach, and corporate strategy with respect to competition. However, some of these commenters also opined

that FDIC action on any application or notice which is based on considerations that are not specifically authorized under the FDI Act would be arbitrary and capricious.

Several commenters supported extending the FDIC's moratorium on deposit insurance applications for new industrial banks and acquisitions of existing industrial banks until Congress has the time to enact legislation prohibiting affiliations between industrial banks and commercial or other entities that are not subject to Federal Consolidated Bank Supervision. Others believed that congressional action is not required and that the FDIC has the authority to deny any industrial bank application or notice if the industrial bank would be controlled by an entity not subject to Federal Consolidated Bank Supervision. Several commenters also asserted that an affiliation between an industrial bank and an entity not subject to Federal Consolidated Bank Supervision – primarily, a commercial entity – presented several safety and soundness concerns, and that industrial banks which serve as a support mechanism for an affiliated entity do not serve the convenience and needs of the community. Another commenter encouraged the FDIC to discontinue its practice of conditioning Federal deposit insurance on a case-by-case basis, arguing that conditions lack a binding effect because they may be removed by the FDIC at a later time. Some commenters suggested restricting affiliations between industrial banks and commercial or other entities without a Federal Consolidated Bank Supervisor by regulation.

*iii. Comments Regarding Commercial Ownership of Industrial Banks*

Some commenters discounted the concerns commonly expressed concerning commercially-owned industrial banks, re-emphasizing that such institutions are subject to regulations that prevent tying and that, they believe, effectively restrict transactions with

affiliates. Other commenters disagreed, contending that commercially-owned industrial banks are more likely to have conflicts of interest than other insured institutions because they have an inherent incentive to advance the interests of their commercial affiliates. According to these commenters, this necessarily requires frustrating the interests of competitors, and creates a propensity for industrial banks to discriminate in the provision of banking services. Some commenters also encouraged the FDIC to prohibit commercial entities from chartering or acquiring an industrial bank because, as mentioned earlier, they believe that the current statutory and regulatory structure does not sufficiently mitigate the risks unique to such institutions.

Some commenters disputed the belief that commercially-owned industrial banks have a significant competitive advantage over other insured institutions because, in their view, unlike a traditional bank, an industrial bank operates under a limited-purpose charter which narrows the range of services an industrial bank may offer. Also, they asserted that there are public benefits obtained when an industrial bank provides banking services to discrete customer groups. Other commenters disagreed, and reiterated their view that industrial banks have an inherent competitive advantage over other depository institutions because industrial banks have greater access to capital, customers, and marketing opportunities through their parent companies. They also argued that access to niche banking services is already provided by community banks, and that some industrial banks have the potential to cause more harm than good because their rapid growth has added a significant amount of insured deposits to the system in recent years, thereby diluting the Federal Deposit Insurance Fund.

Some commenters again stated that conditions should only be imposed on industrial banks on a case-by-case basis because, in their view, conditions cannot, as a matter of law, be imposed uniformly on such institutions. Other commenters reiterated their concern that industrial banks owned by commercial firms present a greater risk to the Federal Deposit Insurance Fund, and again proposed prohibiting commercial firms from owning industrial banks, or at a minimum, making these forms of ownership subject to standard conditions.

*iv. Comments on the Need for Supervisory Change*

Some commenters urged the FDIC to consider the sound performance record to date of the industrial bank industry, and the adverse affect that restricting ownership and growth would have on the dual-banking system. These commenters also argued that the FDIC lacks authority to impose restrictions on industrial banks concerning affiliations, growth, or operations by regulation because industrial banks are explicitly exempt from Federal Consolidated Bank Supervision under the BHCA. In their view, the FDIC's authority is limited to imposing conditions on deposit insurance applications and change in control notices until Congress acts to expand consolidated supervision to cover industrial banks. On the other hand, one commenter urged the FDIC to compare the current landscape of the industrial bank industry to the one that existed when Congress exempted industrial banks from the BHCA, suggesting that Congress did not intend for the exemption to apply to the kind of industrial banks that exist today. Other commenters argued that the FDIC has authority to impose standard conditions on industrial banks by regulation, as

long as such action promotes safety and soundness or mitigates risks posed to the Federal Deposit Insurance Fund. Some commenters favored extending the moratorium until Congress has an opportunity to enact legislation to impose Federal Consolidated Bank Supervision on the owners of all industrial banks.

### III. Necessity For Additional Supervisory Measures

The FDIC's experience suggests no risk or other possible harm that is unique to the industrial bank charter. Rather, the concerns that have been raised focus on the ownership or control of the industrial bank and on the proposed industrial bank's business model or plan. Consequently, the FDIC's analysis below of how to proceed focuses primarily on the entities that would control the industrial bank.

The mission of the FDIC is to promote the stability of, and public confidence in, the nation's banking system. The FDIC's statutory duties include insuring the deposits of all insured depository institutions, and maintaining and administering the Deposit Insurance Fund.<sup>24</sup> While the bank and thrift chartering agencies seek to maintain the safety and soundness of the institutions subject to their jurisdiction, the FDIC has a unique responsibility for the safety and soundness of all insured banks and savings associations in that it is the only agency which has the power to grant deposit insurance to a bank or

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24 See sections 1 & 11 of the FDI Act, 12 U.S.C. 1811, 1821.

savings association, and it is the only agency that has the power to take it away.<sup>25</sup> In granting deposit insurance, the FDIC must consider the factors listed in section 6 of the FDI Act;<sup>26</sup> these factors generally focus on the safety and soundness of the proposed bank or savings association and any risk it may pose to the Deposit Insurance Fund. Similarly, the FDIC can terminate an institution's deposit insurance if the FDIC finds that the institution is engaging in an unsafe or unsound practice or is in an unsafe or unsound condition. Moreover, the FDIC is the sole Federal regulator with responsibility for the safety and soundness of all state nonmember banks, including industrial banks. Not only does the FDIC have the responsibility to decide whether to grant or terminate deposit insurance for state nonmember banks based upon safety and soundness considerations, but it also can issue cease and desist orders and impose civil money penalties based upon safety and soundness considerations.<sup>27</sup> Finally, the FDIC may permit or deny various transactions (e.g., branching, mergers, and changes in bank control) by state nonmember banks based to a large extent on safety and soundness considerations and on its assessment of the risk posed to the Deposit Insurance Fund.<sup>28</sup>

As described above, the FDIC has a statutory duty to monitor, evaluate, and take necessary action to ensure the safety and soundness of state nonmember banks. In order to carry out that responsibility, the FDIC must interpret and apply the law to circumstances that may not have been envisioned or, at least, clearly addressed by statutes written many years in the past. Furthermore, the FDIC has a duty to be

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25 See sections 5 & 8(a) of the FDI Act, 12 U.S.C. 1815, 1818(a).

26 12 U.S.C. 1816.

27 See section 8 of the FDI Act, 12 U.S.C. 1818.

28 See sections 7(j), 18(c), & 18(d) of the FDI Act, 12 U.S.C. 1817(j), 1828(c), & 1828(d).

proactive, not just reactive; the FDIC does not have to wait until problems or losses occur before it takes action. The FDIC believes that recent developments in the industrial bank industry mandate that the FDIC take action now to ensure the safety and soundness of industrial banks and to protect the Deposit Insurance Fund.

As described above, one of the notable recent developments is the significant growth of the industrial bank industry. In its 2005 report on industrial banks, the GAO highlighted the growth in total industrial bank assets. The GAO noted that between 1987 and 2004, industrial bank assets grew over 3,500 percent.<sup>29</sup> The GAO also noted that in 2004, six industrial banks had at least \$3 billion in total assets, and one had over \$66 billion in total assets. The report further stated that this growth was primarily concentrated in a few large industrial banks owned by financial services firms. Moreover, the report indicated that as of the end of 2004, six industrial banks owned \$119 billion in assets or eighty-five percent of the total industrial bank industry assets and controlled about \$64 billion in insured deposits.<sup>30</sup> Finally, the GAO noted that between 1999 and 2005 the insured deposits held by all industrial banks grew by more than 500 percent.<sup>31</sup>

Also, as noted above, industrial bank powers have expanded significantly since the first industrial bank was chartered. When the first industrial banks were chartered, their powers were generally limited to consumer lending. However, as time progressed, the

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29 See GAO Report 05-621, p. 18.

30 *Id.*

31 See *Id.* at 20.

states that chartered industrial banks expanded their powers to the extent that today many industrial banks have virtually the same powers as a state commercial bank.<sup>32</sup>

Another circumstance that has raised concerns is the interest shown by large companies in owning industrial banks. Some of these companies are engaged in activities that are predominantly commercial in nature, e.g., manufacturing, retail sales, and trucking. Some of these companies tend to utilize their subsidiary industrial banks in ways that involve unusual, affiliate-dependent business plans. It has been argued that despite the statutory limitations on transactions with affiliates and on tying between banks and their affiliates, there is nevertheless a substantial potential for conflicts of interest in the absence of Federal Consolidated Bank Supervision. Specifically, a bank may have a strong incentive to take risks, especially credit risks, that it would not otherwise deem prudent or it may engage in illegal tying conduct in order to aid its parent company or other affiliates.

A further consideration is that the banking industry as a whole has enjoyed a period of extraordinary economic stability in the recent past. There have been no bank or thrift failures in over two and one-half years – a record in the recent history of banking. As a result, the financial viability of industrial banks that are owned by companies not subject to consolidated oversight is largely untested in times of economic stress or a downturn in

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32 California industrial banks currently have the same powers as California commercial banks except that industrial banks are not permitted to offer demand deposits. *See* Cal. Fin. Code §§ 1401, 1411, & 1412. Utah industrial banks have essentially the same powers as Utah commercial banks except that industrial banks have more limited securities powers and less specific investment authority than commercial banks. *See* Utah Code Ann., Title 7, Chapters 1, 3, & 8. Nevada industrial banks have essentially the same powers as Nevada commercial banks, except for certain insurance and securities

the economy. There is almost no track record that indicates how such ownership structures might perform under stress and, specifically, whether such ownership would tend to cause or exacerbate any risks to the subsidiary industrial banks or the Deposit Insurance Fund.

Consolidated Federal supervision generally includes reporting, examination, and minimum capital requirements that provide, at a minimum, transparency for the early identification of emerging risks in the affiliated entities. In addition, to the extent that a bank's parent company can serve as a source of strength to the subsidiary bank under Federal Consolidated Bank Supervision, the bank has an additional resource for capital should its financial condition deteriorate. The sometimes limited transparency of companies that are not subject to consolidated oversight makes it more difficult to identify and to control these risks before they may become significant risks to the industrial bank subsidiary. Also, such companies may have no expectation that they should serve as a source of strength to their subsidiary banks. Furthermore, it has been argued that since regulation necessarily imposes a cost on the regulated entity, it is unfair, from a competitive standpoint, to allow companies that control one or more industrial banks to conduct essentially the same business as bank holding companies, financial holding companies, or thrift holding companies that are subject to Federal Consolidated Bank Supervision. It has been argued that to continue to permit this situation would provide an incentive to those institutions that are subject to Federal Consolidated Bank Supervision to migrate to the industrial bank model. Such an incentive would seem

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powers, which require the approval of the Commissioner of Financial Institutions. *See Nev. Rev. Stat. § 657.005, et seq.*

contrary to Congress's long-standing preference for Federal Consolidated Bank Supervision.

The main concerns regarding an industrial bank being controlled by another company or layers of companies that lack Federal Consolidated Bank Supervision include (i) the mixing of banking and commerce when a commercial company controls an industrial bank, (ii) the need for the parent company to serve as a source of capital for the subsidiary industrial bank, and (iii) the difficulty in identifying problems or risks that may develop in the company or its subsidiaries and controlling or preventing the extent to which they impact the industrial bank. The FDIC believes that it can deal with the latter two concerns in the manner detailed by the proposed rules

Banks that are owned by one or more individuals, of course, have neither a parent company nor parent company subsidiaries, and as a result, they generally do not present the same potential for problems as banks owned by companies. Industrial banks that are controlled by companies, however, do present some significant risks. Because industrial banks are generally excluded from the definition of "bank" under the BHCA, companies, whether engaged in commercial activities or financial activities, that own an industrial bank would not necessarily be subject to Federal Consolidated Bank Supervision.

Because the financial services industry continues to evolve to meet the needs of the marketplace, the regulation of insured depository institutions needs to continue to evolve to accommodate those changes. In that regard, the FDIC's views on the supervision of

industrial banks to be owned by companies have also evolved. While any one of the developments that have occurred in the industrial bank industry over the last two decades might not, in isolation, be sufficient to warrant regulatory action, the convergence of all of these developments at this point in time argues for caution and for an approach designed to provide greater transparency and to limit potential risks to industrial banks and to the Deposit Insurance Fund resulting from control by companies that are not subject to Federal Consolidated Bank Supervision. The adoption of a set of comprehensive safeguards would provide a Federal set of standards and requirements<sup>33</sup> that the FDIC can apply and enforce independent of the state authorities in a manner that fulfills the FDIC's mission efficiently and to the fullest extent possible.

The FDIC believes that it is prudent to limit or control the exposure presented by some of these ownership structures by imposing controls on them now before there is a substantial proliferation of them. There is no reason to believe that interest in industrial banks will subside; in fact, there is a good possibility that it may intensify. If problems were to develop once a large number of industrial banks are controlled by companies not subject to consolidated oversight, the risks could be magnified greatly and become more difficult to address than if appropriate regulatory action is taken now.

The FDIC recognizes that companies that are only engaged in financial activities are engaged in activities that are generally well-understood by, or at least, familiar to, the Federal banking agencies. The FDIC also recognizes that the Federal banking agencies

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33 While some of the chartering states do have supervisory authority over companies that control

generally have effective systems and procedures for dealing with the risks presented by most financial activities. However, unlike companies subject to Federal Consolidated Bank Supervision, financial companies that are not subject to consolidated federal supervision (Non-FCBS Financial Companies) that own industrial banks may not provide the same level of transparency nor the same opportunity for supervisors to deal with the risks. As deposit insurer and as the primary Federal banking supervisor for industrial banks, the FDIC must ensure that the risks arising from the business activities of the owners of insured industrial banks do not impair the safety and soundness of those industrial banks or impose undue risks on the Deposit Insurance Fund. This requires a focus on the risks from the insured institution's activities as well as the activities of its owner. Where insured industrial banks are owned by Non-FCBS Financial Companies, it is increasingly important for the FDIC to exercise its powers as deposit insurer and as the primary Federal banking supervisor for industrial banks to provide oversight to control the risks that may be created by such owners.

The regulatory action that the FDIC is proposing today is directed only at industrial banks that will become subsidiaries of Non-FCBS Financial Companies, that is, companies that (i) are engaged only in financial activities, and (ii) are not subject to Federal Consolidated Bank Supervision. As noted in the notice of limited extension of the moratorium published elsewhere in the Federal Register today, the FDIC is not proposing any changes in its regulation or supervision of industrial banks that will be directly controlled by one or more individuals. Furthermore, the FDIC is not proposing any changes in its

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industrial bank subsidiaries, that is not true of all of the states that charter industrial banks.

regulation or supervision of an industrial bank that will become a subsidiary (direct or indirect) of an FCBS Financial Company, that is, a company that (i) is engaged only in financial activities and (ii) is subject to Federal Consolidated Bank Supervision (i.e., a bank holding company, a financial holding company, or a savings and loan holding company). With respect to industrial banks that will be owned by companies engaged in commercial activities, the FDIC is extending the moratorium to allow more time for study by the FDIC and to allow time for Congress to consider the issues presented by such an ownership model. In publishing the proposed rules, and in extending the moratorium for one year, the FDIC is not expressing any conclusion about the propriety of control of industrial banks by commercial companies. Rather, the FDIC has determined that it is appropriate to provide additional time for review of such ownership and the related issues by the FDIC and by Congress.

As noted above, the proposed rules are limited in their application to industrial banks that will become subsidiaries of Non-FCBS Financial Companies. The current limitation is essential to limit any change in the nature of the corporate owner's business to financial activities until such time as the moratorium expires or other appropriate action is taken by the FDIC or Congress.

Access to current and complete information about the potential risks to an insured industrial bank that may be created by the operations of its parent company or its affiliates is especially critical today because of the speed with which an industrial bank or its parent company can move into new and more risky business operations. Changes in

the overall corporate focus of the owners of even well-rated institutions could lead to participation in risky or emerging activities that could jeopardize the insured institution's safety and soundness well before supervisory ratings would typically be adjusted. More fundamentally, under current regulations the FDIC may not always have timely access to information about the risks posed by changes in the business focus of parent companies without direct access to these owners. We believe that it is prudent to issue the proposed Part 354 in order to gain an understanding of the emerging risks that may be developing in some of the large and complex companies that may desire to control an industrial bank.

With respect to industrial banks that become subsidiaries of Non-FCBS Financial Companies, the proposed rules are intended to provide the safeguards that the FDIC believes could be helpful to identify and avoid or control, on a consolidated basis, the safety and soundness risks and the risks to the Deposit Insurance Fund that may result from that kind of company-ownership model. The proposed rules would, therefore, provide enhanced transparency and a system of controls that should effectively deal with the risks presented by such ownership structures.

The proposed rules would not apply to industrial banks that are already owned by financial companies not subject to Federal Consolidated Bank Supervision. However, the FDIC will continue to exercise close supervision of these industrial banks and any risks that may be created in the future from their parent companies or affiliates to ensure that these institutions continue to operate in a safe and sound manner.

Finally, while the proposed rules are pending, the FDIC will consider deposit insurance applications and change in control notices with respect to industrial banks that will be controlled by financial companies that are not subject to Federal Consolidated Bank Supervision on a case-by-case basis. After any final rules are adopted, the FDIC will consider requests to modify any conditions and requirements agreed to during the period between issuance of the proposed rules and the effective date of the final rules to conform such conditions and requirements to those in the final rules.

#### IV. Authority For Additional Supervisory Measures

The FDIC has the authority to issue such rules and regulations as it deems necessary to carry out the provisions of the FDI Act<sup>34</sup> including rules to ensure the safety and soundness of industrial banks and to protect the Deposit Insurance Fund.<sup>35</sup> The FDIC also has the authority to issue rules to ensure the safety and soundness of insured depository institutions. As noted above, the mission of the FDIC is to promote the stability of, and public confidence in, the nation's banking system and to protect the Deposit Insurance Fund. Moreover, as deposit insurer, the FDIC has a unique responsibility for the safety and soundness of all insured banks and savings associations. In granting deposit insurance for any insured depository institution, including industrial banks, as well as in terminating it, the FDIC must assess the safety and soundness of the

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

35 See section 8 of the FDI Act, 12 U.S.C. 1818.

institution.<sup>36</sup> The FDIC also can issue a cease and desist order against, or impose civil money penalties on, an industrial bank and any institution-affiliated party (including a parent company of the industrial bank) based upon the FDIC's assessment of safety and soundness considerations.<sup>37</sup> Furthermore, the FDIC can order an industrial bank and its parent company to take other corrective action, e.g., provide indemnification, dispose of any asset, or rescind contracts based upon safety and soundness considerations.<sup>38</sup> Finally, the FDIC may permit or deny various transactions (e.g., branching, mergers, and changes in bank control) by industrial banks based on, at least in part, safety and soundness considerations and risk to the Deposit Insurance Fund.

Also as discussed above, the FDIC has a statutory duty to monitor, evaluate, and take necessary action to ensure the safety and soundness of industrial banks. Courts have recognized that the determination of what is safe and sound is committed to the expertise of the regulatory agencies.<sup>39</sup> The proposed rules reflect the FDIC's concern that, without the provisions detailed in the proposed rules, control of industrial banks by financial companies that are not subject to Federal Consolidated Bank Supervision limits the FDIC's ability to oversee the potential risks to the industrial bank and to the Deposit Insurance Fund from such owners. Importantly, the FDIC has a duty to take appropriate action to guard against threats to the safety and soundness of industrial banks and to the Deposit Insurance Fund; the FDIC does not have to wait until problems or losses occur

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36 See sections 5, 6, & 8(a) of the FDI Act, 12 U.S.C. 1815, 1816, & 1818(a).

37 See section 8(b), (i) of the FDI Act, 12 U.S.C. 1818(b), (i).

38 See section 8(b)(6) of the FDI Act, 12 U.S.C. 1818(b)(6).

39 See *Groos National Bank v. Comptroller of the Currency*, 573 F.2d 889, 897 (5th Cir. 1978), *First National Bank of LaMarge v. Smith*, 610 F.2d 1258, 1265 (5th Cir. 1980).

before it takes action.<sup>40</sup> The FDIC believes that the recent developments in the industrial bank industry described above mandate that the FDIC take action now in the form of the proposed rules to ensure the safety and soundness of industrial banks controlled by such financial companies and to protect the Deposit Insurance Fund.

## V. Discussion Of Proposed Rules

Some of the principal concerns that have emerged regarding industrial banks to be controlled by Non-FCBS Financial Companies center on the transparency of such parent companies and their subsidiaries, the need for a source of strength for the industrial bank subsidiary, capital maintenance, and dependence by the industrial bank on the parent company and its subsidiaries. Generally, the proposed rules would assure, through reporting and examinations, that the FDIC has the ability to obtain transparency with respect to a parent company and its subsidiaries. Furthermore, the proposed rules would require that the parent company serve as a resource for additional capital for the industrial bank. Finally, the proposed rules would provide some control over the dependence of the industrial bank on the parent company and its other subsidiaries. For example, the proposed rules would limit a parent company's representation on the board of a subsidiary industrial bank to 25%. Additionally, the proposed rules also would require prior FDIC approval before the industrial bank may make a material change in its

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<sup>40</sup> See *Independent Bankers Ass'n of Am. v. Heimann*, 613 F.2d 1164, 1169 (D.C. Cir. 1979), cert. denied 449 U.S. 823 (1980); *Investment Company Institute v. FDIC*, 815 F.2d 1540, 1549 (D.C. Cir. 1987); *National Council of Savings Institutions v. FDIC*, 664 F. Supp. 572 (D.D.C. 1987) *see also* *First Nat'l Bank of Lamarque v. Smith*, 610 F.2d 1258 (5th Cir. 1980).

business plan or add or replace a board member or senior executive officer during the first three years after becoming a subsidiary of a financial company.

The conditions and requirements proposed in part 354 are not novel. In many cases financial companies, e.g., companies engaged in securities or mortgage lending, come under some type of supervision already and, therefore, are used to some form of regulatory scheme and supervision. Moreover, some of the requirements that would be imposed by these proposed rules have been imposed in the past on a case-by-case basis. For example, in the course of considering deposit insurance applications or change in control notices, the FDIC has required parent companies to execute written agreements to maintain a subsidiary bank's capital and liquidity at certain minimum levels; in addition, the FDIC has required that a bank maintain its capital at a certain level and obtain the FDIC's prior consent before it changes its business plan or replaces a board director. The FDIC has concluded that the statutory objectives of maintaining the safety and soundness of industrial banks and controlling the risks to the Deposit Insurance Fund would be furthered if the proposed requirements were imposed uniformly on all industrial banks that are to be owned by Non-FCBS Financial Companies. The following is a section-by-section discussion of the proposed rules.

#### Section 354.1 Scope

This section describes the industrial banks that are subject to the requirements detailed in part 354. The requirements described in the following sections of part 354 are in addition to the statutory and regulatory requirements otherwise applicable to applications and

notices filed with respect to such industrial banks. The industrial banks that are subject to the following requirements are those that will, after the effective date of the rules, become subsidiaries of companies that are engaged solely in financial activities and that are not subject to Federal Consolidated Bank Supervision by the FRB or the OTS, that is, Non-FCBS Financial Companies. The proposed rules would apply to such industrial banks whether they become subsidiaries of such Non-FCBS Financial Companies as a result of the grant of deposit insurance to a newly-chartered industrial bank, as a result of a change in control with respect to the industrial bank, or as a result of a merger or consolidation of a parent company of the industrial bank with one or more other companies. Thus, this part would not apply to any industrial bank that will, after the effective date of the rules, become a subsidiary of any company that is engaged solely in financial activities and that is, or will be, subject to Federal Consolidated Bank Supervision by the FRB or the OTS, that is, a FCBS Financial Company. In addition, this part does not apply to any industrial bank that will be wholly, and directly, owned by one or more individuals (i.e., the industrial bank will not be controlled, directly or indirectly, by any company). Finally, this part does not apply to any industrial bank that will become a subsidiary of any company engaged in non-financial activities (i.e., activities other than financial activities as that term is defined in section 354.2).

#### Section 354.2 Definitions

This section lists the definitions that apply to this part. The term “control” would be defined as it is in the FDIC’s change in control regulations at 12 CFR 303.81(c) and specifically would include the rebuttable presumption of control at 12 CFR 303.82(b)(2).

Under these provisions a person (including a company) would control an industrial bank if the person would have the power, directly or indirectly, to (i) vote 25 percent or more of any class of voting shares of any industrial bank or any company that controls the industrial bank (i.e., a parent company), or (ii) direct the management or policies of any industrial bank or any parent company. In addition, the FDIC presumes that a person would have the power to direct the management or policies of any industrial bank or any parent company if the person will, directly or indirectly, own, control, or hold with power to vote at least 10 percent of any class of voting shares of any industrial bank or any parent company, and either the industrial bank's shares or the parent company's shares are registered under section 12 of the Securities Exchange Act of 1934, or no other person (including a company) will own, control or hold with power to vote a greater percentage. If two or more persons (including companies), not acting in concert, will each have the same percentage, each such person will have control. As noted above, control of an industrial bank can be indirect. For example, company A may control company B which in turn may control company C which may control an industrial bank. Company A and company B would each have indirect control of the industrial bank, and company C would have direct control. As a result, the industrial bank would be a subsidiary (as defined below) of each such company. The term "financial activity" would be defined to include any activity that either of the following entities may engage in: (i) a financial holding company, as described in the BHCA and the implementing regulations of the FRB,<sup>41</sup> or (ii) a savings and loan holding company, as described in the Home Owners' Loan Act ("HOLA"). The FDIC intends to follow the written guidance

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41 Bank holding companies are not separately listed because financial holding companies can engage in every activity that a bank holding company can.

of the FRB and OTS in its interpretations of the term “financial activity” and to consult with the FRB and/or OTS before making any decisions. The term “Non-FCBS Financial Company” would be defined to mean any company that is not subject to Federal Consolidated Bank Supervision and that is engaged solely in financial activities. This definition, therefore, would exclude financial companies that are subject to Federal Consolidated Bank Supervision by the FRB or OTS (“FCBS Financial Companies”), as well as commercial companies. The term “industrial bank” would be defined to mean any insured state bank that is an industrial bank, industrial loan company or other similar institution that is excluded from the BHCA definition of “bank.” The term “senior executive officer” would have the meaning given to it in the FDIC’s regulations on changes in senior executive officer at 12 CFR 303.101(b). The term “subsidiary” would be specifically defined to mean any company which is controlled, directly or indirectly, by another company. Finally, the terms “company” and “insured depository institution” would have the meanings given them in the FDI Act.

#### Section 354.3 Written Agreement

This section would prohibit any industrial bank from becoming a subsidiary of a Non-FCBS Financial Company unless the Non-FCBS Financial Company enters into one or more written agreements with the FDIC and the industrial bank. In such agreements the company would make certain commitments to the FDIC including those listed in paragraphs (a) through (h) of section 354.4 and such other provisions as the FDIC may deem appropriate in the particular circumstances. When two or more financial companies will control (as the term “control” is defined in section 354.2), directly or

indirectly, the industrial bank, each such financial company would have to execute such written agreement(s). This circumstance could occur, for example, (i) when two or more Non-FCBS Financial Companies will each have the power to vote 10% or more of the voting stock of an industrial bank or of a company that controls an industrial bank which stock is registered under section 12 of the Securities Exchange Act of 1934, or (ii) when one Non-FCBS Financial Company will control another financial company that directly controls an industrial bank.

#### Section 354.4 Conditions and Provisions of Written Agreement

This section would include a list of the commitments that the Non-FCBS Financial Company would agree to observe. There are eight commitments lettered (a) through (h); they 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 are controlled by Non-FCBS Financial Companies. In order to provide the FDIC with more timely and more complete information about the activities, financial condition, operations, and risks of each parent Non-FCBS Financial Company and its subsidiaries, the FDIC believes that each such Non-FCBS Financial Company that controls the industrial bank must furnish the FDIC an initial listing, with annual updates, of all of the company's subsidiaries (commitment (a)); consent to the FDIC's examination of the company and each of its subsidiaries (commitment (b)); submit to the FDIC an annual report on the company and its subsidiaries, and such other reports as the FDIC may request (commitment (d)); maintain such records as the FDIC deems necessary to assess the risks to the industrial bank and to the Deposit Insurance Fund

(commitment (e)); and cause an independent annual audit of each subsidiary industrial bank to be performed during the first three years after the industrial bank becomes its subsidiary (commitment (f)). In order to ensure that each Non-FCBS Financial Company parent remains a financial company, it would also have to commit that it will engage, directly or indirectly, only in financial activities (commitment (c)). In order to ensure that the subsidiary industrial bank maintains sufficient capital and/or liquidity, each parent financial company would commit to maintain each industrial bank subsidiary's capital and/or liquidity at such levels as the FDIC deems appropriate and/or take such other action as the FDIC deems appropriate to provide each industrial bank with a resource for additional capital/or liquidity (commitment (h)). Finally, in order to limit the extent of each parent financial company's influence over the subsidiary industrial bank, each such company would commit to limit its representation on the industrial bank's board of directors to 25% of the members of the board, or if the bank is organized as a limited liability company and is managed by a board of managers, to 25% of the members of the board of managers, or if the bank is organized as a limited liability company and is managed by its members, to 25% of managing member interests (commitment (g)). For example, if company A controlled company B which had 15% representation on the industrial bank's board, company B's representation would be attributed to company A, and company A would be limited to 10% direct representation on the bank's board.

This section would also provide that each approval of a deposit insurance application and each issuance of a non-objection to a change in control with respect to an industrial bank

that would become a subsidiary of a financial company would be conditioned on each parent Non-FCBS Financial Company complying with (a) through (h) of the commitments.

#### Section 354.5 Restrictions on Industrial Bank Subsidiaries of Financial Companies

This section would require the FDIC's prior written approval before an industrial bank that becomes a subsidiary of a Non-FCBS Financial Company may take certain actions. These restrictions, like the commitments discussed above, are generally 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 financial companies not subject to Federal Consolidated Bank Supervision. Accordingly, the proposed rules would require prior FDIC approval if the subsidiary industrial bank wanted to take any of five actions. In order to ensure that the industrial bank does not immediately after becoming a subsidiary of a Non-FCBS Financial Company engage in high-risk or other inappropriate activities, the bank would have to get the FDIC's prior approval to make a material change in its business plan during the first three years after becoming a subsidiary of a financial company (paragraph (a)). In order to limit the influence of its parent Non-FCBS Financial Company, the bank would have to get the FDIC's prior approval to add or replace a member of the board of directors or board of managers or a managing member, as the case may be, during the first three years after becoming a subsidiary of a financial company (paragraph (b)); add or replace a senior executive officer during the first three years after becoming a subsidiary of a financial company (paragraph (c)); employ a senior executive officer who

is associated in any manner with an affiliate of the industrial bank, e.g., as a director, officer, employee, agent, owner, partner, or consultant of the financial company or a financial company subsidiary (paragraph (d)); or finally, enter into any contract for essential services with the financial company or a financial company subsidiary (paragraph (e)).

### **REQUEST FOR COMMENTS:**

The FDIC is seeking comments on all aspects of the proposed rules, including the following questions:

1. The requirements described in this notice would apply to industrial banks that become subsidiaries of companies that are engaged solely in financial activities, but that are not subject to Federal Consolidated Bank Supervision, and to those financial companies (“Non-FCBS Financial Companies”). Some of the provisions include continuing requirements, e.g., to maintain capital or to engage only in financial activities. Should the regulations include a cure period in the event that the industrial bank or its parent company initially comply with these requirements, but later fall out of compliance? If so, should such a cure period be provided for all requirements or just some of them (please specify)? For example, section 4(m) of the BHCA, 12 U.S.C. 1843(m), generally provides a 180-day cure period for a financial holding company if any of its subsidiary depository institutions fails to be well-capitalized and/or well-managed.

2. With regard to such continuing requirements, whether or not there is a cure period, should the rules provide for remedies beyond cease and desist orders and civil money penalties, e.g., should violations of some of these requirements require divestiture of the industrial bank similar to the divestiture provisions in section 4(m)(4) of the BHCA, 12 U.S.C. 1843(m)(4)? If so, for which requirements? Should the written agreement with the parent company and the industrial bank include a provision requiring the parent company to divest the industrial bank if the parent company begins to engage, directly or indirectly, in non-financial activities? Alternatively, should the FDIC simply rely on section 8(b)(7) of the FDI Act, 12 U.S.C. 1818(b)(7), to order divestiture?<sup>42</sup>

3. Under the Bank Holding Act, a commercial company that becomes a bank holding company has a period of time after becoming a bank holding company subject to the supervision of the FRB in which to divest itself of its nonconforming commercial activities or, alternatively, of its bank(s). Should a commercial company seeking to acquire an industrial bank and to divest itself of its commercial activities so that it would become a Non-FCBS Financial Company similarly be given a period of time by the FDIC within which it would be subject to the FDIC's supervisory oversight, but would be allowed to divest itself of its commercial activities or its industrial bank(s)? If so, for what period of time?

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42 Section 8(b)(7) generally provides that in the event that an institution-affiliated party engages in an unsafe or unsound practice, violates any law, regulation, or condition imposed in writing in connection with the granting of any application or request by the depository institution, or any written agreement entered into with the agency, the FDIC may "place limitations on the activities or functions of an insured depository institution or any institution-affiliated party." The term "institution-affiliated party" would include a company that is a controlling stockholder of the bank and any person who has filed or is required to file a change in control notice with the FDIC.

4. Should the FDIC further define “services essential to the operations of the industrial bank” as that phrase is used in the proposed section 354.5(e)? Should the restriction in that section be clarified to include core banking services or risk management functions?
  
5. For purposes of transparency and identifying any potential risks to the industrial bank, we have included commitments requiring examination and reporting. Is this approach the best way to gain that transparency, or is there a better way? To what extent, if any, is the FDIC’s supervision enhanced by requiring a parent company of an industrial bank to consent to examination of the company and each of its subsidiaries as proposed in part 354? Is there another way to identify any potential risks?
  
6. Is it appropriate for the FDIC to impose reporting and recordkeeping requirements on a parent company of an industrial bank and/or the parent company’s subsidiaries?
  
7. The Gramm-Leach-Bliley Act of 1999 imposed certain restrictions on the extent to which a Federal banking agency may regulate and supervise a functionally-regulated affiliate of an insured depository institution.<sup>43</sup> For example, such restrictions limit the FDIC’s authority to require reports from, examine, and impose capital requirements on such a functionally-regulated affiliate. In view of these restrictions, should the conditions and requirements contained in the proposed rules be modified to the extent that they might apply to insurance companies and securities companies that may wish to control an industrial bank?

8. The proposed regulation does not apply to a financial company that is supervised by the FRB or the OTS. Should this treatment be extended to a financial company that is subject to consolidated Federal supervision by the U.S. Securities and Exchange Commission as a “consolidated supervised entity” pursuant to 17 CFR 240.15c3-1(a)(7), 240.15c3-1e, 240.15c3-1g, 240.17a-4(b)(12), 240.17a-5(a)(5) and (k), 240.17a-11(b)(2) and (h), 240.17h-1T(d)(4), and 240.17h-2T(b)(4)?

9. In order to ensure that each parent financial company can serve as a source of strength to its industrial bank subsidiary and fulfill its obligation under a capital maintenance agreement, should the FDIC include a commitment that the parent company will maintain its own capital at such a level that the Tier 1 capital ratio for the company, on a consolidated basis, is at least 4% or some other level in some or all circumstances?

10. If, at the conclusion of the moratorium, Congress has not acted on legislation, how should the FDIC address the pending and any future applications by commercial companies?

## **Regulatory Analysis and Procedure**

### *A. Solicitation of Comments on Use of Plain Language*

Section 722 of the Graham-Leach-Bliley Act requires the Federal banking agencies to use “plain language” in all proposed and final rules published after January 1, 2000. The FDIC invites comments on whether the proposed rules are clearly written and if not, how the language of the proposed rules might be improved.

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43      *See* section 45 of the FDI Act, 12 U.S.C. 1831v.

B. *Regulatory Flexibility Act*

When an agency issues a rulemaking proposal, the Regulatory Flexibility Act (“RFA”)(5 U.S.C. 601 et. seq.) requires the agency to prepare and make available for public comment an initial regulatory flexibility analysis (5 U.S.C. 603) or certify, in lieu of preparing an analysis, that the proposed rules, if adopted, would not have a significant economic impact on a substantial number of small entities. (5 U.S.C. 605). The proposed rules directly affect two types of entities: (i) any financial company that is not subject to Federal Consolidated Bank Supervision that after the effective date of the rules becomes the parent company of an industrial bank, and (ii) the financial company’s subsidiary industrial bank formed or acquired after the effective date of the rules. Based on its experience with deposit insurance applications and change in control notices involving industrial bank subsidiaries of financial companies (as defined in the proposed rules) from 1996 through 2005, and focusing particularly on the period from 2001 through 2005, the FDIC estimates for purposes of the threshold RFA analysis that in the future the proposed rules will affect an average of three entities per year; only one of which will be a small entity. One entity is not a substantial number. Therefore, the FDIC certifies that the proposed rules will not have a significant economic impact on a substantial number of small entities.

C. *Paperwork Reduction Act*

In accordance with the Paperwork Reduction Act (44 U.S.C. 3501 et. seq.), the FDIC may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid Office of Management and Budget (OMB)

control number. The collection of information contained in the proposed rules has been submitted to OMB for review.

ADDRESSES: Interested parties are invited to submit written comments to the FDIC concerning the Paperwork Reduction Act implications of this proposal. Such comments should refer to “PRA-Industrial Banks.” Comments on Paperwork Reduction Act issues may be submitted by any of the following methods:

- <http://www.FDIC.gov/regulations/laws/federal/propose.html>.
- E-mail: [comments@FDIC.gov](mailto:comments@FDIC.gov). Include “PRA - Industrial Banks” in the subject line of the message.
- Mail: Steve Hanft (202-898-3907), Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429.
- Hand Delivery: Comments may be hand-delivered to the guard station at the rear of the 17th Street Building (located on F Street), on business days between 7 a.m. and 5 p.m.
- A copy of the comments may also be submitted to: OMB desk officer for the FDIC, Office of Information and Regulatory Affairs, Office of Management and Budget, New Executive Office Building, Washington, D.C. 20503.

Comment is solicited on:

- (1) Whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;
- (2) The accuracy of the agency's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;

- (3) The quality, utility, and clarity of the information to be collected; and
- (4) Ways to minimize the burden of the collection of information on those who are to respond, including the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology; e.g., permitting electronic submission of responses.
- (5) Estimates of capital or start-up costs and costs of operation, maintenance, and purchases of services to provide information.

*Title of the collection:* Industrial Banks

*Summary of the collection:* The collection consists of reporting and recordkeeping requirements associated with the supervision of insured industrial loan companies or industrial banks that become subsidiaries of financial companies after the effective date of the rules. More specifically, the collection consists of an initial listing of all of the company's subsidiaries, and an annual update to that list; an annual report regarding the company's operations and activities; occasional other reports regarding the activities, financial condition, risk monitoring systems, transactions with the subsidiary industrial bank, and compliance with Federal laws, of, or by, the company and each of its subsidiaries; quarterly reports on capital ratio calculations; external audits; Board membership; maintenance of capital and liquidity; maintenance of certain records; and notices and applications seeking FDIC approval to take certain actions. These information collections are contained in sections 354.4 and 354.5 of the rules.

*Frequency of the collection:* For the listing of all of the company's subsidiaries, and the report regarding the company's operations and activities, the frequency of response is

annual; the other collections occur on occasion.

*Annual burden estimate:*

Estimated number of respondents: Three

Estimated annual burden per respondent: 255 burden hours

Total estimated annual burden: 765 burden hours

### **The Treasury and General Government Appropriations Act, 1999--Assessment of Impact of Federal Regulation on Families**

The FDIC has determined that this proposal will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999, Public Law 105-277, 112 Stat. 2681.

#### **List of Subjects in 12 CFR Part 354**

Bank deposit insurance, Banks, Banking, Finance, Holding companies, Industrial banks, Insurance, Reporting and recordkeeping requirements, Savings associations.

For the reasons set forth in the preamble, the Board of Directors of the Federal Deposit Insurance Corporation proposes to add 12 CFR part 354 as follows:

## **PART 354 – INDUSTRIAL BANK SUBSIDIARIES OF FINANCIAL COMPANIES**

1. The authority for part 354 is as follows:

Authority: 12 U.S.C. 1811, 1815, 1816, 1817, 1818, 1819(a) (Seventh) and (Tenth), 1820(g), 3108, 3207.

### **Part 354**

#### **§ 354.1 Scope**

#### **§ 354.2 Definitions**

#### **§ 354.3 Written Agreement**

#### **§ 354.4 Conditions and Provisions of Written Agreement**

#### **§ 354.5 Restrictions on Industrial Bank Subsidiaries of Financial Companies**

#### **§ 354.1 Scope.**

(a) This part, in addition to applicable notice or application procedures in Part 303 of this Chapter, establishes certain requirements for an industrial bank to become, after the effective date of the rules, a subsidiary of a company that is engaged solely in financial activities and that is not subject to Federal Consolidated Bank Supervision by the Federal Reserve Board (FRB) or the Office of Thrift Supervision (OTS) (a “Non-FCBS Financial Company”).

(b) This part does not apply to

- (1) any industrial bank that will become, after the effective date of the rules, controlled by a company that is engaged solely in financial activities and that is subject to Federal Consolidated Bank Supervision by the FRB or the OTS,
- (2) any industrial bank that will not become a subsidiary of a company, and
- (3) any industrial bank that will become, after the effective date of the rules, a subsidiary of a company engaged in non-financial activities.

**§ 354.2 Definitions.**

For purposes of this part the following definitions apply.

- (a) The term “control” has the meaning given it in 12 U.S.C. 1817(j)(8) and 12 CFR 303.81(c) and includes the rebuttable presumption of control at 12 CFR 303.82(b)(2).
- (b) The term “financial activity” includes
  - (1) banking, managing or controlling banks or savings associations;
  - (2) any activity permissible for financial holding companies under 12 U.S.C. 1843(k), any specific activity that is listed as permissible for bank holding companies under 12 U.S.C. 1843(c) and activities that the Federal Reserve Board (FRB) has permitted for bank holding companies under 12 CFR 225.28 and 225.86, and
  - (3) any activity permissible for all savings and loan holding companies under 12 U.S.C. 1467a(c).
- (c) The term “Non-FCBS Financial Company” means a company that is not subject to Federal Consolidated Bank Supervision by the FRB or the OTS, and that is solely engaged, directly or indirectly, in financial activities.

- (d) The term “industrial bank” means any insured State Bank that is an industrial bank, industrial loan company or other similar institution that is excluded from the definition of “bank” in the Bank Holding Company Act (BHCA) pursuant to 12 U.S.C. 1841(c)(2)(H).
- (e) The term “senior executive officer” has the meaning given it in 12 CFR 303.101(b).
- (f) The term “subsidiary” means any company which is controlled, directly or indirectly, by another company.
- (g) The terms “company” and “insured depository institution” have the meanings given them in section 3 of the Federal Deposit Insurance Act, 12 U.S.C. 1813.

### **§ 354.3 Written Agreement**

No industrial bank may become a direct or indirect subsidiary of a Non-FCBS Financial Company unless the Non-FCBS Financial Company enters into one or more written agreements with the FDIC and the subsidiary industrial bank which contain commitments by the company to comply with each of paragraphs (a) through (h) in section 354.4 and such other provisions as the FDIC deems appropriate in the particular circumstances.

### **§ 354.4 Conditions and Provisions of Written Agreement**

The commitments required to be made in the written agreements referenced in section 354.3 by each Non-FCBS Financial Company that will control an industrial bank are listed as paragraphs (a) through (h) below. In addition, each grant of deposit insurance and each issuance of a non-disapproval of a change in control with respect to an

industrial bank subject to this part will be conditioned on each parent Non-FCBS Financial Company complying with paragraphs (a) through (h) below:

- (a) submitting to the FDIC an initial listing of all of the company's subsidiaries, and updating that list annually;
- (b) consenting to examination of the company and each of its subsidiaries to monitor compliance with the provisions of the Federal Deposit Insurance Act or any other Federal law that the FDIC has specific jurisdiction to enforce against such company or subsidiary and those governing transactions and relationships between any depository institution subsidiary and its affiliates;
- (c) engaging, directly or indirectly, only in financial activities;
- (d) submitting to the FDIC an annual report regarding the 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 keep the FDIC informed as to financial condition, systems for monitoring and controlling financial and operating risks, and transactions with depository institution subsidiaries of the company; and compliance by the company or subsidiary with applicable provisions of the Federal Deposit Insurance Act or any other Federal Law that the FDIC has specific jurisdiction to enforce against such company or subsidiary;
- (e) maintaining such records as the FDIC may deem necessary to assess the risks to the industrial bank or to the Deposit Insurance Fund;
- (f) causing an independent annual audit of each subsidiary industrial bank to be performed during the first three years after the industrial bank becomes a subsidiary of the company;

- (g) limiting its representation, direct and indirect, on the board of directors or board of managers, as the case may be, of each subsidiary industrial bank to no more than 25% 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, limiting its representation as a managing member to no more than 25% of the managing member interests of the subsidiary industrial bank, in the aggregate;
- (h) maintaining the subsidiary industrial bank's capital and liquidity at such levels as the FDIC deems appropriate, and/or taking such other actions as the FDIC deems appropriate to provide the industrial bank with a resource for additional capital and liquidity including, for example, pledging assets, obtaining and maintaining a letter of credit, and indemnifying the industrial bank.

**§ 354.5 Restrictions on Industrial Bank Subsidiaries of Financial Companies**

Without the FDIC's prior written approval, no industrial bank that becomes a subsidiary of a Non-FCBS Financial Company after the effective date of the rules shall:

- (a) make a material change in its business plan during the first three years after becoming a subsidiary industrial bank,
- (b) add or replace a member of the board of directors, board of managers, or a managing member, as the case may be, of the subsidiary industrial bank during the first three years after becoming a subsidiary industrial bank,
- (c) add or replace a senior executive officer during the first three years after becoming a subsidiary industrial bank,

- (d) employ a senior executive officer who is associated in any manner (e.g., as a director, officer, employee, agent, owner, partner, or consultant) with an affiliate of the industrial bank, or
- (e) enter into any contract for services essential to the operations of the industrial bank (for example, loan servicing function) with its parent financial company or any subsidiary thereof.

Dated at Washington, D.C., this \_\_\_\_ day of January 2007.

Authorized to be published in the Federal Register by Order of the Board of Directors of the Federal Deposit Insurance Corporation.

Robert E. Feldman,  
Executive Secretary.