International Bancshares
Corporation

May 28, 2020

Via email: comments@fdic.gov
Via electronic submission: https://www.fdic.gov/regulations/laws/federal

Robert E. Feldman
Executive Secretary
Attn: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: RIN 3064-AF31, "Parent Companies of Industrial Banks and Industrial Loan Companies

Dear Sir or Madam:

The following comments are submitted by International Bancshares Corporation ("IBC"), a publicly-traded, multi-bank financial holding company headquartered in Laredo, Texas. IBC maintains 187 facilities and 284 ATMs, serving 88 communities in Texas and Oklahoma through five separately chartered banks ranging in size from approximately $397 million to $90 billion, with consolidated assets totaling approximately $12.5 billion. IBC is one of the largest independent commercial bank holding companies headquartered in Texas.

This letter responds to the request by the Federal Deposit Insurance Corporation (the "FDIC") for comment on a proposed rule that would require "Covered Companies"—companies that are not subject to the consolidated supervision of the Federal Reserve Board (the "FRB")—and insured industrial banks or industrial loan companies (collectively, "ILCs") to satisfy certain conditions, make certain commitments, and enter into certain written agreements with the FDIC in order for the FDIC to grant its approval of or non-objection to any deposit insurance application, change in control notice, or merger application resulting in an ILC becoming a subsidiary of a Covered Company.

IBC commends the FDIC's stated objectives to reinforce its supervisory authority over ILCs, mitigate the unique risks posed by unregulated Covered Companies and their ILC subsidiaries, and facilitate transparency regarding the FDIC's treatment of ILC filings. In theory, the proposed rule would establish heightened regulatory and supervisory standards for ILCs to finally fill in the gap created by the absence of consolidated federal oversight that ILCs otherwise enjoy. In practice, however, the conditions and commitments imposed under the rule fall short of achieving their intended heightened regulation, operating instead to: (a) expand the "non-bank bank" loophole that ILCs and

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their non-financial parent companies have long enjoyed while leaving them unburdened by federal regulatory hurdles like the Bank Holding Company Act (the "BHCA) and aspects of the Community Reinvestment Act that full-service banks must comply with; (b) enable ILCs to carry out banking activities as mere add-ons to their primary commercial or fintech businesses, thereby disregarding Congress' clear intent to separate banking from commerce and diminishing the ability of full-service community banks like IBC to compete in the banking business until they are ultimately driven out of the industry altogether; and (c) threaten the safety and soundness of the Deposit Insurance Fund (the "DIF") by exposing the DIF to the unmitigated and unregulated risks of ILCs controlled by commercial firms. The illusive oversight and inconsequential nature of the commitments imposed under the rule are demonstrated by the FDIC's recent approval of Square, Inc.'s deposit insurance application despite the pervasive risks posed by the applicant. For these reasons, IBC strongly opposes the FDIC's proposed rule as well as the apparent revival of the FDIC's willingness to approve ILC deposit insurance applications regardless of the safety and soundness risks they present.

The proposed rule expands the "non-bank bank" loophole and makes FDIC approval of deposit insurance applications for commercially-owned ILCs more attainable, thereby undercutting the rule's purported oversight and regulatory requirements.

As the FDIC is well aware, ILCs are expressly exempt from the definition of "bank" under the BHCA. 12 U.S.C. 1841(c)(2)(H). This so-called "non-bank bank" exemption provides a perplexing loophole to regulation by the BHCA pursuant to which parent companies of ILCs can take unfair advantage. Because ILCs are not considered banks, the parent companies controlling them are not considered bank holding companies ("BHCs") and are thus not subject to the BHCA, including its prohibition of BHCs engaging in non-banking activities. While firms engaged in commercial activities are prevented from controlling full-service banks, the loophole enables them to own and control ILCs.

As explained in a 2012 report by the Government Accountability Office (the "GAO"), this loophole is "an integral part of the parent holding company's business model." U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-160, BANK HOLDING COMPANY ACT: CHARACTERISTICS AND REGULATION OF EXEMPT INSTITUTIONS AND THE IMPLICATIONS OF REMOVING THE EXEMPTIONS 34 (2012). "Almost all representatives from exempt institutions that are owned by commercial holding companies told [the GAO] that" the "likely outcome" of removing the BHCA exemptions would be divestment by the holding companies of their exempt institutions. *Id.* at 33. ILC parent companies, no longer able to evade the BHCA's ban on engaging in commercial activities, would face greater difficulty "compet[ing] against larger, more diversified commercials banks" and could face "reduce[d] revenues" that would likely necessitate "changes in their business models[.]" *Id.* at 33–34. The GAO report indicates that ILC parent companies use their exemption from the BHCA and freedom from consolidated federal oversight to gain a competitive edge over BHCs and the full-service banks that they hold. The proposed rule will enable Covered Companies to double down on their exploitation of this regulatory absence. With the ability to control entities that are not only BHCA-exempt but, under the proposed rule, also FDIC-insured, Covered Companies will be given unprecedented, inexpensive access to insured funding

that they will divert for non-banking business purposes, thereby magnifying their unfair competitive advantage over full-service banks in the banking industry.

Although the proposed rule aims to provide greater oversight and regulation of Covered Companies and their non-bank ILC subsidiaries, the effect of the reporting and evaluation commitments are inadequate to sufficiently close the loophole or mitigate the risks that commercially-owned ILCs present, and the purported supervision pales in comparison to the consolidated federal oversight of the FRB. If the FDIC's recent abandonment of the ILC application moratorium it had imposed since 2006 and approval of Square, Inc.'s and Nelnet, Inc.'s federal deposit insurance applications indicate how the FDIC will decide ILC filings moving forward, then the proposed conditions and commitments and their attempt to provide greater oversight and regulation appear to be significantly inadequate. One of the main purposes of the proposed rule is to "ensure that the parent company that owns or controls an industrial bank serves as a source of financial strength for the [ILC]" in compliance with Section 38A of the Federal Deposit Insurance Act and "that a subsidiary [ILC] has available to it the resources necessary to maintain sufficient capital and liquidity." 85 Fed. Reg. 17,771, 17,772, 17,779 (proposed Mar. 31, 2020) (to be codified at 12 C.F.R. pt. 354). To achieve this objective, the proposed rule requires the parent company to provide various financial reports to the FDIC, to consent to the FDIC's assessment of the parent company's and ILC's compliance with any written agreements, and to commit by written agreement "to maintain each subsidiary [ILC]'s capital and liquidity at such levels as the FDIC deems necessary for the safe and sound operation of the industrial bank." *Id.* at 17,779.

As demonstrated by the FDIC's approval of Square, Inc.'s deposit insurance application, the FDIC is willing to ignore a parent company's realistic inability to serve as a source of strength for the ILC so long as the parent company checks off the various conditions and commitments established by the FDIC. In his statement opposing Square, Inc.'s application, FDIC Board Member Martin J. Gruenberg explained that "[t]he weaknesses which make the ability of [Square, Inc.] to meet the financial source of strength requirement highly uncertain – lack of profitability [the company has not been profitable since its 2009 establishment], reliance on an originate to distribute business model, and the dependence of the proposed [ILC] on the parent – also make it very challenging for [Square, Inc.'s] application to satisfy a number of the statutory factors the FDIC must consider in its review." Martin J. Gruenberg, Member, FDIC Bd. of Dirs., Statement on Application for FDIC: Square Financial Services, Inc. (Mar. 17, 2020).

Instead of heeding those glaring red flags, the FDIC attempted to mitigate the company's risks and shortcomings by imposing unusual and extraordinary capital and liquidity conditions in order to ultimately approve Square, Inc.'s application. These mitigation conditions, however, "are insufficient to compensate for [Square, Inc.'s] unproven business model that would be highly vulnerable to an economic downturn." *Id.* With the safety and soundness of the DIF at risk, there is no room for creativity in the FDIC's crafting of conditions under the proposed rule. The conditions and commitments are used by the FDIC as a means to an end to approve ILC applications rather than as meaningful safeguards to evaluate the viability and financial strength of a proposed parent-company–ILC-subsidiary relationship. The great lengths that the FDIC took to justify its approval of

Square, Inc.'s application shows the ineffectiveness of the proposed rule and the risk that results from gauging a parent company's level of financial strength by its perceived ability to satisfy subjective criteria in the future despite the consistent financial weakness that has defined its past. This provides an unfair advantage and an un-level playing field.

The proposed rule will create silos of ILC competitors owned by commercial and fintech firms that will provide specialized banking services as an add-on to their primary non-banking businesses, which will inhibit the ability of full-service community banks to compete in the banking industry.

The proposed rule provides an avenue for non-banking commercial and fintech companies to own and operate ILCs, allowing these parent companies to hone in on individual sectors of the banking industry and utilize their ILC subsidiaries to provide individual, specialized banking services that are ancillary to the parent companies' primary non-banking business purposes. As the number of ILCs increases and the list of specific banking services they offer expands, the field narrows of products and offerings that full-service banks can provide. The ability to offer a full range of services to meet customers' diverse banking needs that once defined the utility of full-service banks will no longer be a viable business model. Instead, the silos of commercial and fintech non-bank competitors will eventually force full-service community banks out of the banking industry.

The diminishing ability of full-service banks to compete with ILCs in the banking industry is intensified by the freedom from federal consolidated regulation and oversight that ILCs enjoy. Functioning as the equivalents of full-service banks, ILCs reap all of the benefits of offering banking services without facing any of the federal regulatory prohibitions or safety and soundness standards by which full-service banks are governed. Most notably and as previously mentioned, unlike ILCs, full-service banks are prohibited from becoming commercial company subsidiaries, which aligns with the longstanding policy to separate banking and commerce. Due to the BHCA loophole, ILCs are left unregulated and free to evade the banking and commerce distinction, allowing them to maximize their economic power in ways that full-service banks cannot while avoiding the onerous oversight by which full-service banks are restricted.

"When certain participants in the financial sector (or their parent companies) are allowed to offer everything that an insured commercial bank can offer (including deposit insurance) without having to adhere to the regulatory constraints that come with access to deposit insurance, then an entire class of participants in the financial services sector is placed at a severe disadvantage and the 'free market' isn't really free." Camden R. Fine, *Square's ILC Bid is a Regulatory End Run*, AM. BANKER (Feb. 28, 2019), https://www.americanbanker.com/opinion/squares-ilc-bid-is-a-regulatory-end-run.
Backed by the DIF safety net and free from the crippling federal regulation that community banks face, non-banking ILC parent companies are able to focus the endeavors of their ILCs on the core elements of the banking business without incurring the regulatory costs that community banks pay. The ability to offer core banking services at low prices enables ILCs to steal business from community banks and robs them of a competitive position in a no longer free or fair market.

Approving the deposit insurance applications of ILCs owned by unregulated commercial firms stretches the scope of the DIF's federal safety net beyond insured banking activities and poses severe risks to the DIF.

In response to Walmart's 2005 deposit insurance application, over 640 general comments were submitted to the FDIC that "specifically focused on the risk posed to the [DIF] by [ILCs] owned by commercial companies or by holding companies with a Federal consolidated bank supervisor." Moratorium on Certain Industrial Loan Applications and Notices, 72 Fed. Reg. 5,290 (Feb. 5, 2007). In response, the FDIC declared the moratorium to evaluate "whether there are emerging safety and soundness issues or policy issues involving industrial banks or other risks to the insurance fund" and whether changes should be enacted to "the FDIC's oversight of industrial banks in order to protect the [DIF] or important Congressional objectives." *Id.* The same policy concerns that prompted the FDIC's 2006 moratorium on ILC applications persist today, and the conditions established in the proposed rule do not provide a sufficient regulatory infrastructure to mitigate the risks that ILCs and their parent companies pose to the DIF.

Affording ILCs the same deposit insurance protections and benefits as full-service banks spreads the DIF's safety net too thin. By insuring ILCs, the FDIC is ultimately insuring the non-banking activities of commercial and fintech ILC parent companies. The tradeoff for the burdensome regulation and intense federal supervision that traditional banks and BHCs undergo is protection by the FDIC and inclusion in the DIF's safety net. FDIC members are willing to relinquish power to federal oversight authorities, forego participation in profitable commercial activities, and comply with arduous regulations in exchange for the stability and support that comes from being FDIC-insured. Expanding the DIF to cover non-banking activities counteracts this fair exchange to the detriment of the full-service banking industry responsible for funding the FDIC in the first place. The FDIC has an obligation to protect the interests of the industry that pays the deposit insurance premiums. The proposed rule thwarts that obligation. Providing ILC parent companies with access to the DIF directly undermines the business interests of current FDIC members, especially those of the community banks that are most at risk of being destabilized by these ILCs.

One of the FDIC's six core values is to "respond quickly and successfully to risks in insured depositary institutions and the financial system." *Mission, Vision, and Values*, FDIC, https://www.fdic.gov/about/strategic/strategic/mission.html (last updated Dec. 18, 2019). Yet by enabling non-banking Covered Companies to enjoy the benefits of FDIC insurance for their ILCs without any of the oversight that the full-service banking industry endures, the FDIC *creates* the very risk that it is tasked with protecting against. Deposit insurance is what allows community banks to compete. Insuring against the risks that ILCs and their parent companies present casts the DIF's safety net far beyond its intended purpose and threatens its stability, thereby diminishing the value of deposit insurance and stripping community banks of their ability to compete in the banking industry.

IBC appreciates the FDIC's commitment to ensuring that commercially-owned ILCs are adequately supervised and regulated and to addressing the unique risks that ILCs and their parent companies present both to the DIF and to the wider banking industry.

However, IBC urges the FDIC to recognize the inadequacy of the proposed rule to accomplish those goals. With the growing interest among commercial and fintech companies to try their hand at banking and to earn the incremental profits that would come from controlling an ILC subsidiary, it is crucial for the FDIC to limit the ability of ILCs to continue taking advantage of the "non-bank bank" loophole and to halt the mounting pressure that silos of ILC competitors will force upon community banks like IBC.

Thank you for the opportunity to share IBC's view.

INTERNATIONAL BANCSHARES CORPORATION

Dennis E. Nixon, President & CEO